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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1954

No. 610

STOCKTON HARBOR INDUSTRIAL COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI
to United States Court of Appeals
for the Ninth Circuit.

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In the Supreme Court
OF THE
United States

October Term, 1954

No.

Stockton Harbor Industrial Company,
Petitioner,
vs.
Commissioner of Internal Revenue.

PETITION FOR WRIT OF CERTIORARI
to United States Court of Appeals for the Ninth Circuit.

Petitioner, Stockton Harbor Industrial Company, by its counsel, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, affirming the decision of the Tax Court of the United States.

OPINIONS BELOW.

The memorandum opinion of the Tax Court is not officially reported but is printed at pages 72-106 of the

Record herein, nine additional copies of which have been filed with the Clerk. The opinion is unofficially reported in 11 TCM 364. The majority and dissenting opinions of the Court of Appeals, printed in Appendix B hereto, infra pp. 55, 94, are reported in 216 F. 2d 638, 656.

JURISDICTION.

The judgment of the Court of Appeals was entered on November 1, 1954 (R. 151). A timely petition for rehearing filed on November 19, 1954 was denied on December 1, 1954 (R. 152). The jurisdiction of this Court is invoked under 28 U.S. Code, Section 1254(1).

QUESTIONS PRESENTED.

1. Whether the acquisition by one corporation of substantially all the properties of another corporation in exchange for stock plus cash, the latter to be used for the payment of some of the indebtedness of the transferor-corporation, can be treated as a transfer "solely for stock" so as to be a tax-free reorganization within the meaning of Section 112(g)(1)(C) of the Internal Revenue Code of 1939, reenacted by Section 368(a)(1)(C) of the Internal Revenue Code of 1954.

2. Whether, under both the 1939 and 1954 Internal Revenue Codes, the requirement that to be tax-free a transfer must be "solely for stock" can be avoided by having the transferor-corporation receive a cash loan from a shareholder of the transferee corporation, although

the receipt of the loan is expressly made a condition precedent to the making of the transfer.

3. Whether the Dobson doctrine continues to govern appeals from the Tax Court, notwithstanding the effort by Congress to overturn it by the enactment in 1948 of the amendment to Section 1141(a) of the Internal Revenue Code of 1939, reenacted without change by Section 7482(a) of the Internal Revenue Code of 1954.

4. Whether the substantial evidence rule restricts appellate review, under both the 1939 and 1954 Internal Revenue Codes, of a finding in the exact language of the statute ("held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"), particularly where the legislative history discloses that Congress used the statutory phrase as a term of art.

5. Whether, under both the 1939 and 1954 Internal Revenue Codes, the fact that a corporation acquired property on its formation with a purpose of ultimate sale at a profit is sufficient by itself to remove the profit from the category of capital gain on the eventual condemnation by the United States and sale of the remainder.

STATUTES INVOLVED.

The statutes involved are Sections 112(g)(1), 113(a)(7), 117(j), and 1141(a) of the Internal Revenue Code of 1939 (Title 26, U.S. Code). They are printed in Appendix A, infra pp. 47-54.

STATEMENT OF THE CASE.

Petitioner came into existence in 1936 owning real property of a value of $380,000 (R. 55, 82), against which there were encumbrances of $128,153.62 (R. 78). Thus at that time petitioner owned a net equity in this property of $251,846.38. As the transaction in which it had acquired its property was unquestionably not a reorganization under the law in effect in 1936, petitioner's property originally had a tax basis equal to its cost to petitioner.[1]

The circumstances of petitioner's creation were found by the Tax Court as follows. Petitioner was incorporated on October 16, 1936 (R. 73) for the purpose of acquiring the real property of Lindley Patrick Farms, Inc. (R. 76-80). Pursuant to a plan which appears from directors' resolutions of both corporations as well as from petitioner's application to the California Commissioner of Corporations for a permit to issue its stock, petitioner sold 601 of its shares to a group of individuals, who can be referred to as the Rawlings group, for $30,000 in cash, and then acquired all the real property of Lindley Patrick Farms, Inc. (hereinafter referred to simply as "Lindley Patrick") for 599 shares of its stock and cash in the amount of $25,655.77. The cash was used by the escrow agent to pay off some of the debts of Lindley Patrick prior to the transfer of assets to petitioner. Petitioner had not agreed to assume these debts but did assume other debts of Lindley Patrick. (R. 76-82.)

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[1] In recognition of this state of the law, the parties treated the transaction as a taxable transaction (R. 82).

In addition, the option which Lindley Patrick gave to Stuart Rawlings at the inception of this transaction required that Rawlings lend $20,000 to Lindley Patrick, the loan to be secured by the pledge of the stock Lindley Patrick was to receive in petitioner (R. 75). The escrow instructions of Lindley Patrick, in which petitioner concurred, required that the loan and pledge be made as a condition precedent to the transfer of Lindley Patrick's real property to petitioner (R. 81). The transaction was carried out this way (R. 82).

Petitioner acquired the real property for the purpose of developing and selling it as industrial property (R. 83). However, petitioner did not subdivide it or lay it out into parcels or as a tract (R. 88), nor does the record contain any evidence that petitioner placed roads, utilities or other improvements on the property. The only advertising petitioner did was to place an advertisement in a commemorative issue of a local paper in 1937, which stated that petitioner was "developing Rough and Ready Island" (R. 84), and to use stationery which stated that petitioner owned "Wharf, Warehouse and Manufacturing Sites", and showing on the reverse a map of the property with a brief description in favorable terms (R. 86-87). The property was not listed with brokers, although in 1942 two members of a firm of real estate brokers were shown over the property, told the prices at which the various parcels could be purchased, and led to understand the usual commission would be paid if they were instrumental in bringing about a sale (R. 66-67, 88-89). Between 1939 and 1941 an agent of petitioner attempted to bring about a sale of the property for shipyard purposes, and

having failed in that he attempted to effect a lease for those purposes, failing in that as well (R. 55-56, 87-88).

In fulfillment of hopes entertained on its formation (R. 83, 41), in 1937 petitioner gave an oil and gas lease on its property. Ultimately a dry hole was drilled and in December, 1941 the lessee abandoned. Petitioner received $5,000 in royalty income from this lease in 1938. (R. 83.) Petitioner leased its property to farmers, receiving both crop and cash rentals in each year it owned the property (R. 83). These rentals reached a high of $12,925.66 in 1943 (R. 84).

All sales or leases were made directly by petitioner's vice president (Stip. par. 16, R. 57).

The tax liability in question arises principally from the condemnation by the United States in 1945 of all of Rough and Ready Island, including 608 acres owned by petitioner. Prior to the actual taking, petitioner had discussed the sale of this property to the Navy at a price of $440,000. In the condemnation proceeding, petitioner received $415,000. (R. 89-90.)

Including sales of two small strips to the State for ship channel improvement and the condemnation by the United States in 1945 for Navy use, petitioner made eight sales of real property during its existence (R. 57-58, 89-90). In addition to the foregoing three parcels, petitioner sold a 13-acre parcel of waterfront property to General Petroleum Company in 1937, another of like size and location to Shell Oil Company in 1940, and sold a 214-acre farm to a farmer in 1944 (R. 57-58, 89-90). Also, petitioner sold a 4.77-acre islet in 1943 for $2,500, and in

1945, after the condemnation by the United States of petitioner's remaining property on Rough and Ready Island, petitioner sold the balance of its property back to Albert Lindley, who had formerly owned it through the medium of Lindley Patrick Farms, Inc. (R. 89, 90).

Petitioner thereupon paid its debts and what it thought was its tax liability, and commenced dissolution proceedings. A distribution in liquidation of $200 a share, totalling $240,000,[2] was made to petitioner's shareholders, leaving petitioner with insufficient assets to pay the tax ultimately asserted by the Commissioner of Internal Revenue (R. 90-91).[3]

Deficiencies were assessed for the years 1943, 1944 and 1945, totalling $281,699.79, plus interest (R. 70, 72). Petitions were filed with the Tax Court, which redetermined the deficiencies at the sum of $266,407.81, plus interest (R. 107, 108), and rejected petitioner's contentions that its basis for computing gain on its real estate transfers was its cost of $380,000 instead of its transferor's basis of $85,545.89 used by the Commissioner in his deficiency letter.[4] The Tax Court held that petitioner must be deemed to have acquired its properties "solely for stock" in spite of the cash payment it made, because the cash was used to pay off debts of Lindley Patrick which

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[2]Petitioner had issued 1200 shares (R. 79).

[3]Transferee proceedings are pending in the Tax Court (Docket Nos. 28873-28882, inclusive) which, if the Commissioner is successful, will result in transferee assessments equal to the distribution received.

[4]Exhibit A to the petition for 1944 and 1945, which was omitted in printing. We have not challenged this figure if our contention that petitioner is entitled to use its cost of $380,000 is rejected.

otherwise petitioner would have had to assume (R. 97-98). The cash loan was also disregarded on the ground it was not consideration but only an "inducement" (R. 98-99). Accordingly, the court held, the acquisition was in a tax-free reorganization under Section 112(g)(1)(C), I.R.C. 1939. The Tax Court held further that the gain was not capital gain under Section 117(j), on the ground that petitioner had acquired the land hoping some day to sell it for a profit, never abandoned that intention, and ultimately succeeded in doing what it had set out to do (R. 102-106). The decision of the Tax Court was a memorandum decision (R. 72) and was not reviewed by the full court.

On appeal, the Court of Appeals for the Ninth Circuit affirmed, one judge dissenting on the reorganization issue (Appendix B, infra pp. 55, 94). District Judge Yankwich, sitting by assignment, wrote the opinion for the court. On the reorganization issue, it too concluded that the cash payment could be ignored and the acquisition treated as being "solely for stock", but for a different reason from that advanced by the Tax Court. The opinion holds that a cash payment used to liquidate "a pre-existing obligation . . . determined and fixed prior to the reorganization" can be ignored (Appendix B, infra pp. 70-71). Judge Chambers dissented on this point. The court held that the cash loan must be ignored as well, because made by one of petitioner's shareholders instead of by petitioner (Appendix B, infra p. 68). Finally the decision below denying capital gain status to the gain was upheld as being a finding of fact supported by substantial evidence (Appendix B, infra pp. 79-80).

REASONS FOR GRANTING THE WRIT.

FIRST QUESTION.

The Court of Appeals and the Tax Court have both failed to follow the decision of this Court in *Helvering v. Southwest Consolidated Co.*, (1942) 315 U.S. 194, and, contrary to that decision, have held that the acquisition by one corporation of substantially all the assets of another corporation is a tax-free reorganization notwithstanding that the acquiring corporation paid, in addition to its own stock, cash to be used for the liquidation of some of the debts of the transferor.[5] The decisions below thus improperly construe Section 112(g)(1)(C) of the Internal Revenue Code of 1939, reenacted without relevant change by Section 368(a)(1)(C) of the Internal Revenue Code of 1954.[6]

This misconstruction of or refusal to follow this Court's *Southwest Consolidated* decision presents a question of importance in the administration of the revenue laws, particularly because in Section 368(a)(2)(B) of the 1954 Code (Appendix A, infra pp. 49-50) Congress has provided an escape provision designed to avoid the rigid application of that case in those situations which Congress thought entitled to relief. The decision below nullifies that escape provision in large measure by reaching the same result the escape provision would authorize, but in a situation expressly excluded from its scope. Moreover, it appears to open a loophole which Congress deliberately

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[5]Circuit Judge Chambers dissented on this issue.

[6]Both in Appendix A, infra pp. 48-49. They require that the transfer be in exchange "solely . . . for stock."

intended to close, in order to reach a harsh, unfair and unnecessary result.

Furthermore, the decision below conflicts with the decisions of two other courts of appeals, that for the Tenth Circuit in *Central Kansas Tel. Co. v. Commissioner,* (1944) 141 F. 2d 213, and that for the Sixth Circuit in *Adwood Corporation v. Commissioner,* (1952) 200 F. 2d 552.

The opinion below does not, unfortunately, recognize its conflict with any of these decisions. While its effect on the new provision Section 368(a)(2)(B) is evident enough, discussion is necessary to demonstrate the conflict with those decisions.

(a) The decision below has decided a federal question in conflict with applicable decisions of this Court.

Petitioner acquired substantially all the property of Lindley Patrick Farms, Inc. in 1936. The real property acquired was then worth $380,000 (R. 82) and was subject to encumbrances totalling $128,153.62, which petitioner assumed (R. 78). As additional consideration, petitioner gave 49 per cent of its stock and $25,655.77 in cash, inter alia. The escrow instructions of Lindley Patrick, in which petitioner concurred, required that the escrow agent receive from petitioner both the stock and the cash before Lindley Patrick's deed to the realty could be delivered to petitioner. The cash was used by the escrow agent to pay several debts of Lindley Patrick. (R. 76-78, 80-81.)

Petitioner's basis for the real property, when it acquired it in 1936, was $380,000, that being its cost to petitioner. This would clearly follow from petitioner's

assumption of $128,153.62 of Lindley Patrick's indebtedness, if there were nothing else to support that conclusion. *United States v. Hendler,* (1938) 303 U.S. 564. Therefore the acquisition was a purchase, not a tax-free reorganization.

The Commissioner contends, however, and the lower courts held, that the retroactive Hendler amendments, enacted by Congress in 1939 to overrule the Hendler case,[7] reduced petitioner's basis from $380,000 to about $90,000. Petitioner would have to concede that that was so if its acquisition of the property had been solely for stock and the assumption of indebtedness. That it was not, however, for petitioner also paid cash.

One of the conditions of petitioner's acquisition of the real property was that it pay $25,655.77 in cash to the escrow agent, which cash the parties contemplated would be used to pay some of Lindley Patrick's debts. (R. 76, 80-82.) Petitioner duly paid the cash and the escrow agent used it to pay certain of Lindley Patrick's debts prior to the transfer of the land to petitioner (R. 82). This cash constituted additional consideration so in point of fact petitioner did not acquire the land "solely for stock".

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[7]The substance of these amendments was to add the following language to the several tax-free exchange provisions:

Sec. 112(b)(5): "Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, * * *."

Sec. 112(1)(g)(c): "* * * the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, * * *."

Sec. 112(k): "* * * assumes a liability of the taxpayer or acquires from the taxpayer property subject to a liability, * * *."

Sec. 113(a)(6): "* * * assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, * * *."

Petitioner can use its cost as its basis, instead of being retroactively required to use Lindley Patrick's lower basis, unless it acquired the land "solely for stock" within Section 112(g)(1)(C) of the 1939 Code.[8] In *Helvering v. Southwest Consolidated Corporation,* (1942) 315 U.S. 194, this Court held that, even after the Hendler amendments, where a corporation acquires property for stock plus some cash which is used to pay some of the transferor's debts, the acquisition is not "solely for stock" under the very code sections herein involved.[9] We maintain that the *Southwest Consolidated* case should have foreclosed the issue in petitioner's favor.

The lower courts not only refused proper application to the *Southwest Consolidated* case but to settled principles established by this Court in other cases which pointed to the same result under the statute involved herein and in the light of which the new Section 368(a)(2)(B) must be interpreted. The analysis based on those decisions proceeds as follows:

The cash paid by petitioner constituted income to Lindley Patrick even if it was paid by the escrow agent directly to Lindley Patrick's creditors *(Old Colony Trust Co. v. Commissioner,* (1929) 279 U.S. 716; *U.S. v. Boston & M. R.R.,* (1929) 279 U.S. 732); for this reason, cash paid for the property by the acquiring corporation which

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[8]Now Sec. 368(a)(1)(C) of the 1954 Code.

This result follows from the fact that cost is petitioner's basis under Sec. 113(a) unless the property was acquired "in connection with a reorganization." Sec. 113(a)(7). See Appendix A, infra p. 48, for text.

[9]In *Southwest Consolidated* as here, the question was the basis of property to the acquiring corporation.

is used to pay Lindley Patrick's debts spoils the reorganization under Section 112(g)(1)(C) (*Minnesota Tea Co. v. Helvering,* (1938) 302 U.S. 609).

In *United States v. Hendler* (1938) 303 U.S. 564, this Court applied the rationale of the foregoing cases in such manner as to give rise to the fear that that rationale would mean that the mere assumption by the acquiring corporation of the transferor's debts, even absent the provision for their immediate payment which was present in the *Hendler* case, would constitute additional consideration which would spoil a reorganization. The Hendler amendments were therefore enacted, one of which changed Section 112(g)(1)(C), the provision herein involved, to permit an acquisition to be treated as "solely for stock" even though there is an "assumption by the acquiring corporation of a liability of the other".

The Congressional concern with liabilities which were assumed instead of being liquidated in the course of the acquisition is stated in the committee report (H. Rep. No. 855, 76th Cong., 1st Sess.; 1939, 2 C.B. 504, 518):

> "* * * *If,* in addition to such stock or securities, other property or *money is received, gain is recognized* to the extent of such other property or money.
>
> "The recent Supreme Court case of *United States v. Hendler* (303 U.S. 564 (1938)) has been broadly interpreted to require that, if a taxpayer's liabilities are assumed by another party in what is otherwise a tax-free reorganization, gain is recognized to the extent of the assumption. *In typical transactions changing the form or entity of a business it is not customary to liquidate the liabilities of the business and such liabilities are almost invariably assumed by the corpo-*

> *ration which continues the business.* Your committee therefore believes that such a broad interpretation as is indicated above will largely nullify the provisions of existing law * * *." (Emphasis ours.)[10]

It is against this background that the *Southwest Consolidated* case (315 U.S. 194) was decided by this Court. It involved an insolvency reorganization in which a bondholders' committee formed a new corporation to buy in the assets of the old corporation from the indenture trustee. The trustee borrowed funds from a bank with which the dissenting bondholders could be and were paid off by the new corporation, which issued its stock to the majority bondholders. This Court held that in view of the cash paid by the new corporation to the dissenting bondholders, the acquisition by the new corporation was not "solely for stock." The Hendler amendment was held applicable only to assumptions of indebtedness, not to cash payments of indebtedness.[11]

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[10]In Surrey, *Assumption of Indebtedness in Tax-Free Exchanges*, 50 Yale Law Journal 1 (1940), the author, then Assistant Legislative Counsel, Treasury Department, discusses this amendment as being designed solely to overrule the *Hendler* case. He states further (at p. 17, footnote) that the "rule of Minnesota Tea Co. v. Helvering, 302 U.S. 609 . . . is still operative . . . Gain will be recognized if the transferee instead of assuming the liabilities, transfers cash to the transferor and the latter uses this cash to discharge the liabilities. [Thus on the exact problem involved herein, Surrey construes the law differently from the court below.] While the tax consequences of the treatment of the transferor's liabilities thus turn on the mechanics of the transfer, it was apparently thought advisable, in order to minimize possible tax avoidance, not to permit any cash to pass tax-free directly to the transferor."

[11]An additional point in the case, without bearing here, is that stock purchase warrants issued to junior creditors were held to be additional disqualifying consideration.

There is language in this Court's opinion in *Southwest Consolidated* which deals with the acquiring corporation's assumption of that bank loan which was the source of the cash which the acquiring corporation used to pay off the dissenting bondholders. 315 U.S. at 199-200.[12] This language misled the Court of Appeals into the conclusion that the cash payment by the acquiring corporation in this case could be disregarded. The lower court confined the cash payment rule of the *Southwest Consolidated* case to those debts of the transferor which "are determined and fixed in the reorganization" (Appendix B, infra pp. 70, 76), and for some reason not clearly expressed conceived that the debts here which were paid with the cash were not "determined and fixed in the reorganization." However, the theory of the Tax Court, adopted in its opinion, was that the plan contemplated the payment by petitioner of Lindley Patrick's "pressing current liabilities" (R. 95), and further "that there was never any thought or intention but that the moneys paid to the escrow agent should be applied to the clearing of the charges for delinquent interest and taxes" (R. 98). The appellate court's meaning is therefore not clear.

The other possible interpretation of the decision below, based on the first paragraph at Appendix B, page

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[12]Speaking of that assumption, this Court said (315 U.S. at 200): "Though the liability assumed had its origin in obligations of the transferor, its nature and amount were determined and fixed in the reorganization."

With this language this Court dismissed the contention that the assumption of liability brought the case within the Hendler amendment. The substance of the transaction, the Court held, was a cash payment to preexisting creditors of the transferor which constituted additional consideration to the latter and upset the reorganization.

73, is that the lower court considers the holding in *Southwest Consolidated* about the disqualifying effect of cash payments of transferor's debts to apply only to debts which "originate in the reorganization." This, however, entirely perverts language which was used by this Court to eliminate the significance of an assumption, into a limitation on the type of cash payment which will disqualify a reorganization. The decision below is plainly mistaken, for a cash payment whether used to pay off the transferor's debts or not, is neither "stock" nor an "assumption of liability", and only those two classes of consideration are permissible.

(b) The 1954 Code intensifies the dangerous effect of the decision below.

Section 368(a)(1)(C) of the 1954 Code continues without change the provision formerly in Section 112(g)(1)(C), under which an acquisition must be "solely for stock" and "assumption . . . of a liability" to be a tax-free reorganization. However, a new provision, Section 368(a)(2)(B), entitled "Additional Consideration in Certain Paragraph (1)(C) Cases", permits the acquiring corporation also to pay a certain amount of cash for the property in some cases.[13] The instant case would not qualify under that escape provision, but because of the decision below, it would nevertheless escape under the basic statute, on account of a cash payment which would not qualify under the portion of the new Code deliberately enacted to provide escapes.

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[13]All three provisions are in Appendix A, infra pp. 48-50.

The new section allows a transaction to be a tax-free reorganization if at least 80 per cent of the fair market value of the property is acquired for stock. If cash paid plus liabilities assumed do not total more than 20 per cent of the fair market value of the property acquired, the cash payment will not disqualify the transaction, whereas if together the cash and assumed liabilities total more than 20 per cent, the cash payment spoils the reorganization.[14]

Petitioner paid cash of $25,655.77 and assumed liabilities of $128,153.62, for a total of $153,809.39 (R. 77-78). The land acquired was worth $380,000 (R. 82), and other assets totalling $17,626.24 were also acquired (R. 82). The cash plus assumed liabilities thus totalled 39 per cent of the fair market value of the acquired property, and the stock issued represented 61 per cent of that value, which percentages disqualify the transaction under the new escape provision.

Accordingly, the departure in this case from the *Southwest Consolidated* rule raises a serious question of the application of the new statute, particularly of the new escape provision, to acquisitions in part for cash, where the cash is used to pay some of the transferor's debts. This is an important question in the administration of the revenue laws which can be settled by this Court merely by its insistence that its decision in *Helvering v. Southwest Consolidated Corporation* (1942), 315 U.S. 194, be adhered to.

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[14]Examples showing this intended effect quite clearly are given in the committee report (S.Rep. 1622, 83d Cong., 2d Sess., pp. 274-275), of which the relevant portion is reproduced in Appendix A, infra pp. 50-51.

(c) The decision below conflicts with decisions of two other courts of appeals.

For the same reason that the decision below conflicts with the decision of this Court in *Helvering v. Southwest Consolidated Corporation,* supra, 315 U.S. 194, it conflicts with decisions of two other courts of appeals. In both *Central Kansas Tel. Co. v. Commissioner,* (CA 10, 1944) 141 F. 2d 213, and *Adwood Corporation v. Commissioner,* (CA 6, 1952) 200 F. 2d 552, as in the instant case, the acquiring corporation paid stock plus relatively small amounts of cash for the property of the transferor corporation, the cash to be used to pay off some of the pre-existing debts of the transferor. Those two cases held, contrary to the decision herein, that the cash consideration prevented the transaction's being recognized as a tax-free reorganization.

All four cases are indistinguishable. The conclusion of the other decisions is that the payment of the transferor's debt with cash supplied by the acquiring corporation is neither an assumption of those debts nor an acquisition solely for stock. The lower court herein seized on inconsequential differences in the facts in order to avoid applying those cases here. There is a substantial conflict.

(d) The decision below opens a dangerous loophole in the statute.

Neither the Tax Court nor the Court of Appeals disregarded the cash consideration on any theory of *de minimis.* Accordingly, the decision herein would be the same if the cash consideration had constituted 75 per cent, or even more, of the total consideration paid by petitioner. Such a decision opens a loophole contrary to the intent of Congress.

The reorganization provisions were never intended to apply to acquisitions primarily for cash. This fact was recognized by this Court in *Pinellas Ice & Cold Storage Co. v. Commissioner,* (1933) 287 U.S. 462, where it was applied as a premise to disqualify an acquisition for short-term notes, which were recognized as being tantamount to cash. In the 1934 amendments, Congress approved this interpretation and carried it even further. (H.Rep. 704, 73d Cong., 2d Sess., (1934); 1939-1 C.B. (Pt. 2) 254, 264.)[15] *Helvering v. Southwest Consol. Corp.,* (1942) 315 U.S. 194, 198.

The so-called "parenthetical mergers" under the pre-1934 definition included transactions in which a substantial part of the consideration was cash. (*Nelson Co. v. Helvering,* (1935) 296 U.S. 374.) The parenthetical clause[16] was superseded by clause B, dealing with acquisitions of stock for stock, and clause C, dealing with acquisitions of property for stock.[17] But where before cash or its equivalent, such as short-term notes, could be given in addition to stock, the 1934 amendment required that the exchanges be "solely for stock".[18] The House had proposed that

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[15]This history and purpose have been extensively discussed by one of the authors of this petition in Brookes, *Continuity of Interest Test in Reorganizations,* 34 Cal. L. Rev. 1 (1946). See also Paul, *Studies in Federal Taxation* (3rd Series), pp. 36-41.

[16]"The term 'reorganization' means

"merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation)".

[17]For text, see Appendix A, infra p. 48.

[18]This was generally understood at the time. See Hendricks, *Developments in the Taxation of Reorganization,* 34 Col. L. Rev.

the merger concept be confined to "statutory mergers or consolidations", but the Senate believed this restriction was too strict, principally because many states had no statutes providing for mergers and consolidations,[19] and inserted what are now clauses B and C because transactions covered by them "are in themselves sufficiently similar to mergers and consolidations as to be entitled to similar treatment." The Senate Finance Committee added, "It will be noted that . . . the acquisition . . . must be in exchange solely for the voting stock of the acquiring corporation." (S.Rep. 558, 73d Cong., 2d Sess. (1934); 1939-1 C.B. (Pt. 2) 586, 598-599.)[20]

Accordingly Congress definitely intended to exclude transactions, such as this one, where cash is part of the consideration.[21] That is why this Court held, in the *Southwest Consolidated* case (315 U.S. at 198) that "the

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1198, 1203 (1934); Fahey, *Income Tax Definition of Reorganization*, 39 Col. L. Rev. 933, 959 (1939), where this author said, "The most sweeping change effected by the 1934 definition is the prohibition against the passing of boot from the acquiring corporation in transactions consummated under Part (B) [in 1939 divided into clauses B and C]"; Magill, *Taxable Income* (1936), p. 143, where the author said, "The subdivisions heretofore discussed [present clauses A, B and C] deal with exchanges in which no money had passed"; Magill, *Taxable Income* (Revised Ed., 1945), p. 165. Mr. Magill was the Treasury's spokesman before Congress in the development of the 1934 amendments.

[19]Fahey, *Income Tax Definition of Reorganization*, 39 Col. L. Rev. 933, 948 (1939), states that fourteen states and three federal territories lacked statutory authorization for mergers and consolidations.

[20]This history has been discussed extensively in Brookes, *The Continuity of Interest Test in Reorganizations*, 34 Calif. L. Rev. 1, 8-11 (1946), and more briefly in Paul, *Studies in Federal Taxation*, 3d Series, pp. 39-41.

[21]As documented in footnote 18, supra pp. 19-20, commentators recognized this at the time.

assets of the transferor corporation must be acquired in exchange 'solely' for 'voting stock' of the transferee. 'Solely' leaves no leeway." Because " 'solely' leaves no leeway" a relatively small cash payment to be used for the payment of some of the transferor's debts was held to spoil the reorganization.

The lower court here, in failing to understand what this Court held in *Southwest Consolidated,* has failed to give effect to the deliberate purpose of Congress.[22] If this decision is allowed to stand, transactions having no resemblance to mergers or consolidations, in which large amounts of cash are paid by the acquiring corporation in addition to its stock, will qualify so long as the cash is used for payment of the transferor's debts. These debts may include notes or bonds held by shareholders, thus opening the door to results Congress attempted to prevent.

Moreover, if these holdings are correct, this Court's decision in *Minnesota Tea Co. v. Helvering,* (1938) 302 U.S. 609, becomes meaningless, for its major premise, that cash paid for the liquidation of the transferor's debts spoils the reorganization, is destroyed.

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[22]Prof. Stanley Surrey, Assistant Legislative Counsel of the Treasury at the time the Hendler amendment was enacted, states that Congress deliberately left taxable those transactions in which "the transferee, instead of assuming the liabilities, transfers cash to the transferor and the latter uses this cash to discharge the liability." The legislative decision was, he states, "*in order to minimize possible tax avoidance,* not to permit any cash to pass tax free directly to the transferor." Surrey, *Assumption of Indebtedness in Tax Free Exchanges,* 50 Yale L.J. 1, 17 (emphasis ours).

(e) This erroneous and dangerous decision cannot be supported as the price necessary to reach a fair and just result.

Victory at any cost may be justified if justice and fairness demand that that victory be won. This, though, is not such a case. We do not understand why the Commissioner should believe that the harsh and unjust result reached here is so important as to warrant risking this dangerous precedent.

(1) The tax deficiency imposed is greater than the assets available to pay it. Consequently petitioner's shareholders will lose their original investments, not merely their profit. Transferee proceedings pending against them (Tax Court Docket Nos. 28873-28882, inclusive) will require the shareholders to repay the entire liquidating distribution petitioner paid to them (R. 59-60), which is all they ever received from petitioner, no dividends ever having been paid.

(2) This confiscation of the shareholders' entire investment is the product of federal legislation which is held herein to have reduced the tax basis of petitioner's property retroactively, after the investment had been made, and of federal condemnation of petitioner's property for war use. The result thus is the same confiscation which the Fifth Amendment of the Constitution forbids be accomplished directly.

(3) This unjust result is based on what was thought by Congress to be a relief measure and which was made retroactive for that reason. To construe it harshly as the lower courts have done is to pervert it from a relief measure to a revenue measure of the worst type, contrary to *Claridge Apartments Co. v. Commissioner,* (1944) 323 U.S. 141, 156.

The Commissioner's victory below not only is erroneous but it establishes a precedent dangerous to the revenue while reaching a harsh and unjust result. We submit, therefore, that this Court should not permit this case to stand as a precedent.

SECOND QUESTION.

The lower courts decided another aspect of this case contrary to applicable decisions of this Court, and in so doing created a loophole dangerous to the revenue. Not previously adverted to is the fact that the plan required that Stuart Rawlings, the promoter of the plan and one of petitioner's shareholders, lend $20,000 in cash to Lindley Patrick, the transferor, which it was free to use as it pleased. The loan was secured by the pledge of all of Lindley Patrick's stock in petitioner. (R. 74-75, 80-81.) Under the escrow instructions, the making of the loan was a condition precedent to the transfer of the property from Lindley Patrick to petitioner (R. 80-81).

The lower court rejected our contention that because this loan was a condition precedent to petitioner's acquisition of the property, petitioner's acquisition was not "solely for stock". In so holding, the court refused to agree that in *Minnesota Tea Co. v. Helvering*, (1938) 302 U.S. 609, this Court held that the requirements of the reorganization statute cannot be evaded by having the stockholders perform a step which would be fatal if performed by the corporation. Instead the lower court held that only the consideration going from the acquiring

corporation to the transferor corporation should be considered. (Appendix B, infra p. 68.)

The decision below reopens a dangerous loophole in the statute, one which probably this Court took jurisdiction in *Minnesota Tea Co. v. Helvering, supra,* 302 U.S. 609, in order to close. If, as the lower court held, all that need be done to avoid the requirements of the statute is to have the shareholders of the acquiring corporation pay the disqualifying consideration, instead of having the acquiring corporation do so itself, the avoidance of the statutory requirements becomes simple indeed.

Section 368(a)(2)(B) of the 1954 Code, discussed above at pp. 16-17, in effect ceases to impose any limitations under the decision herein. If the transferor insists on receiving cash, for distribution to its shareholders, in excess of the limited amount permissible under this new provision, the path of circumvention is now brightly lighted by the decision below: all that need be done is have the acquiring corporation's shareholders pay the cash instead. And if they wish to remove all possible doubt, they can call it a loan, thus coming squarely within the decision herein.

The fact that the cash Lindley Patrick received from Rawlings was a loan instead of an outright assignment does not affect our point. If petitioner had been required, as a condition precedent to its acquisition, to make the loan itself, the loan would have disqualified the transaction, because an acquisition for stock plus a cash loan is not "solely for stock" as the statute requires. The dangerous effect of the decision below is therefore the

same as if the cash Lindley Patrick received from Rawlings was an outright transfer.

In opening this loophole, the lower court decided the case contrary to principles established by this Court in *Minnesota Tea Co. v. Helvering, supra,* 302 U.S. 609, *Griffiths v. Helvering,* (1939) 308 U.S. 355, and *Raybestos-Manhattan v. United States,* (1935) 296 U.S. 60.

THIRD QUESTION.

In its decision of the capital gains issue, the Court of Appeals has applied the Dobson doctrine of limitation on appellate review of Tax Court decisions. However, by Section 36 of the Act of June 25, 1948 (62 Stat. 991) Congress amended Section 1141(a) of the Internal Revenue Code of 1939 into its present form[23] for the express purpose of overturning the Dobson doctrine. The statute now requires review of Tax Court decisions "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury."

The decision below is in conflict with decisions of other courts of appeals. Moreover, it presents an important question of federal law which has not been, but should be, settled by this Court.

(a) The lower court applied the Dobson doctrine.

The fact that the Court of Appeals applied the Dobson doctrine to its review of the capital gains issue is evident from several points in the opinion. First, the

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[23]It was reenacted without change in Sec. 7482(a) of the Internal Revenue Code of 1954. For text, see Appendix A, infra p. 54.

court quoted from and cited *Commissioner v. Sunnen*, (1948) 333 U.S. 591, 607, as declaring the governing rule about scope of review of the Tax Court. (Appendix B, p. 57.) The *Sunnen* case was an extension of the Dobson doctrine, and was decided less than three months before Section 1141(a) was amended to overturn that doctrine. In fact, the extract from the *Sunnen* opinion which the Court of Appeals quotes was immediately followed, in the opinion of this Court, by the citation of *Dobson v. Commissioner* (1943), 320 U.S. 489, 321 U.S. 231.[24]

Further evidence that the review below was restricted on the capital gain issue by a return to the Dobson doctrine is in the court's statement that (Appendix B, pp. 79-80):

> "We cannot substitute our judgment for that of the Tax Court, and can only upset the findings if there is no *substantial evidence* to support them." (Emphasis ours.)

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[24]In the report of this case at 216 F. 2d 640 appears an "Author's Note" which is evidently an attempt to answer this point, which we had urged in our petition for rehearing. This "Author's Note" does not appear in the proceedings below as certified by the Clerk of the Court of Appeals, so it evidently was not filed by Judge Yankwich as an amendment to the opinion or as an opinion on rehearing. This "Author's Note" asserts that the *Sunnen* case "states the law as it is today". It then explains the quoted statement with the further remark that "the principle that the findings of the Tax Court based on contradictory evidence will be respected, still obtains, as it did before." This remark is hardly a fair representation of the record herein. The record consists entirely of a stipulation of facts with attached exhibits and the testimony of two witnesses, one taken by deposition, on different subjects, so that it could not possibly be in conflict.

The "Author's Note" admits that if "the facts are not in dispute and wrong legal conclusions are attached to them" the appellate court can reverse. That epitomizes this case: the facts are not in dispute and the only disputed question is which of two statutory classifications applies to them.

The substantial evidence rule does not apply to appellate review "of the District Courts in civil cases tried without a jury." *United States v. United States Gypsum Co.* (1948), 333 U.S. 364, 395; *N.L.R.B. v. Southland Mfg. Co.* (C.A. 4, 1952), 201 F. 2d 244. Findings of a jury may not be upset if supported by substantial evidence, and the same was true of the findings of administrative agencies (*N.L.R.B. v. Columbian Co.* (1939), 306 U.S. 292, 300, and *District of Columbia v. Pace* (1944), 320 U.S. 698) prior to the enactment of the Administrative Procedure Act (5 U.S. Code Sec. 1009(e)); see *Universal Camera Corp. v. N.L.R.B.* (1951), 340 U.S. 474, 482-487). However, decisions of district courts sitting in civil cases are reversible if "clearly erroneous" under Rule 52(a) of the Rules of Civil Procedure, even if there is substantial evidence to support them. *United States v. United States Gypsum Co.* (1948), 333 U.S. 364, 395. It is this rule, and not the substantial evidence rule, which applies under I.R.C. Section 1141(a), because the review is the same as of "decisions of the district courts in civil actions tried without a jury."

The former rule governing review of administrative agencies (i.e., the substantial evidence rule) was applied with full force to the review of Tax Court decisions by the Dobson doctrine. Stern, *Review of Findings of Administrators, Judges and Juries,* 57 Har. L. Rev. 70, 108. Thus, in *Commissioner v. Scottish-American Inv. Co.* (1944), 323 U.S. 119, 124, the court said:

> ". . . the appellate courts are limited to a determination of whether (the findings) have any substantial basis in the evidence. The judicial eye must

> not in the first instance rove about. . . . It must be cast directly and primarily upon the evidence in support of (the finding) made by the Tax Court."

The Court of Appeals here not only stated that it was bound by the substantial evidence rule but it proceeded to observe the admonition quoted immediately above quite carefully. It culled the evidence which it thought supported the Tax Court,[25] and concluded by saying (Appendix B, p. 94):

> "In what precedes we have indicated some of the facts, representations and admissions in the record which support the conclusion of the Tax Court that the property was held primarily for sale to customers in the ordinary course of business. 26 U.S.C. Sec. 117 (j)(1)(B). *Our review cannot go beyond such inquiry.*" (Emphasis ours.)

This is not the "clearly erroneous" rule which governs appellate review of district courts (*U. S. v. United States Gypsum Co.,* 333 U.S. at 395), but is the old Dobson rule as exemplified by the *Scottish-American* case.

It is evident, we submit, that the Court of Appeals has reverted to the Dobson doctrine, failing to observe that the 1948 legislation was designed to overturn it and expand the scope of review.

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[25]The record consists of a lengthy stipulation of facts and attached exhibits, and the testimony of two witnesses which, being about different subjects, does not conflict. The testimony of Mr. Wilhoit, referred to in the opinion below, was taken by deposition. The Tax Court did not see this witness.

(b) The decision below conflicts with decisions of other courts of appeals.

In so restricting its scope of review and in failing to note that its duty was to determine if the decision below was clearly erroneous, the Court of Appeals has decided the instant case in conflict with decisions in other circuits. Its decision is in conflict with the rule applied by the Court of Appeals for the Fifth Circuit in *Benton v. Commissioner* (1952), 197 F. 2d 745, 753, and *A. C. Burton & Co. v. Commissioner* (1951), 190 F. 2d 115, 116; by that for the Sixth Circuit in *Tennessee, Alabama & G. Ry. Co. v. Commissioner* (1951), 187 F. 2d 826, 832, and *Wright-Bernet, Inc. v. Commissioner* (1949), 172 F. 2d 343; by that for the Fourth Circuit in *Commissioner v. Nubar* (1950), 185 F. 2d 584, 589; and by that for the Eighth Circuit in *Dillon v. Commissioner* (1954), 213 F. 2d 218.[26] It also conflicts either with the silent application of the new statute or with expressions concerning its effect in *Industrial Trust Co. v. Commissioner,* (C.A. 1, 1953), 206 F. 2d 229, *George Kemp Real Estate Co. v. Commissioner* (C.A. 2, 1950), 182 F. 2d 847, *Stearns Magnetic Mfg. Co. v. Commissioner* (C.A. 7, 1954), 208 F. 2d 849, and *Victory Housing No. 2, Inc v. Commissioner* (C.A. 10, 1953), 205 F. 2d 371.[27]

(c) The question is important.

The Court of Appeals has decided an important question of federal law which has not been, but should be,

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[26]The *Dillon* case involved the same substantive question as that herein. The *Rider* case (*Rider v. Commissioner,* (CA 8, 1952) 200 F. 2d 524), relied on below, is an earlier case from the Eighth Circuit evidently not followed by that court in the *Dillon* case.

[27]The *Victory Housing* case also involved the same substantive question presented herein.

settled by this Court. Appeals from the Tax Court may well be the largest single category of appellate court business. The importance of the scope of review to be applied in their determination is attested to by the fact that between December 20, 1943 and June 25, 1948, this Court considered the scope of that review under the old rule at least once each year. *Dobson v. Commissioner* (1943), 320 U.S. 489; *Commissioner v. Scottish-American Inv. Co.* (1944), 323 U.S. 119; *Bingham's Trust v. Commissioner* (1945), 325 U.S. 365; *John Kelley Co. v. Commissioner* (1946), 326 U.S. 521; *Bazley v. Commissioner* (1947), 331 U.S. 737; *Commissioner v. Sunnen* (1948), 333 U.S. 591.

Although the present rule has now been in effect since September 1, 1948, this Court has not considered its scope.[28] It has been reenacted without change in Section 7482(a) of the 1954 Code (Appendix A, infra p. 54). Since there now appears to be confusion as to its meaning, at least in the minds of the court below, this Court should clarify and declare the rule. This case, in which the rule has been misapplied, is an appropriate vehicle for doing so.

This Court has already reviewed and settled the effect of a companion provision in the Taft-Hartley Act which was enacted the same day as the amendment herein involved. *Universal Camera Corp. v. N.L.R.B.*, (1951) 340 U.S. 474; *N.L.R.B. v. Pittsburgh S.S. Co.*, (1951) 340

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[28]Nothing in the opinion of *Brown Shoe Co. v. Commissioner*, (1950) 339 U.S. 583, suggests that this Court found it necessary to consider the new statute, although the Court of Appeals had done so (*Commissioner v. Brown Shoe Co.*, (CA 8, 1949) 175 F. 2d 305, 308).

U.S. 498. The Court did so when the courts of appeals of five circuits agreed that the Taft-Hartley amendment made no material change in the reviewing power, and a single court of appeals held otherwise. *Universal Camera Corp. v. N.L.R.B.*, 340 U.S. 474, at 476, footnote. The situation here is the obverse for, as noted in the point immediately above, the courts of appeals for seven circuits have held that the 1948 amendment to I.R.C. Section 1141(a) broadened the scope of review and apparently only that for the ninth circuit holds otherwise. This Court has observed that the June 25, 1948 amendment in the Taft-Hartley Act expressed a mood of Congress. *Universal Camera Corp. v. N.L.R.B.*, 340 U.S. 474, at 487. It is only reasonable to suppose that the same mood was expressed in the cognate amendment to Section 1141(a) enacted on the same day. Yet the lower court's interpretation of its scope of review herein is irreconcilable with an expansion of the scope of review held to have been accomplished by the companion statute. *Universal Camera Corp. v. N.L.R.B.*, 340 U.S. 474.

Accordingly, to the extent any authority can be found on this issue in the decisions of this Court, it is contrary to the decision below. Since the problem is one which arises in a large group of appellate cases, the proper scope of review under the 1948 amendment to Section 1141(a) should be settled by this Court.

FOURTH QUESTION.

The Court of Appeals has held that the limitations on the scope of review of questions of fact apply also to the review of mixed questions of fact and law. This was the Dobson doctrine. *Dobson v. Commissioner,* (1943) 320 U.S. 489, 501-502; *Bingham's Trust v. Commissioner,* (1945) 325 U.S. 365, 370; *John Kelley Co. v. Commissioner,* (1946) 326 U.S. 521, 527, 529-530; Paul, "*Dobson v. Commissioner: The Strange Ways of Law and Fact*", 57 Har. L. Rev. 753, 828-832, passim; Stern, *Review of Findings of Administrators, Judges and Juries,* 58 Har. L. Rev. 70, 99, 102-109. This aspect of the Dobson doctrine was probably the one which was most severely criticized (Paul, op. cit.), and which may have been most responsible for its legislative reversal.

The decision below, in returning to that aspect of the Dobson doctrine, is in conflict with decisions of other courts of appeals in the application of the very substantive provision involved herein (Sec. 117(j) of the 1939 Internal Revenue Code, reenacted without change by Section 1231 of the 1954 Code). Moreover, in refusing independent consideration to the meaning and application of a statute in the light of its legislative history and course of construction, the decision below presents an important question of federal law which has not been, but should be, settled by this Court.

(a) The decision below conflicts with decisions of other courts of appeals.

The question presented below was whether petitioner held its real property "primarily for sale to customers in the ordinary course of (its) trade or business". If it

did, as the Tax Court held, the gain on the condemnation and sale was excluded from recognition as capital gain under either Section 117(a) or Section 117(j).[29]

The decision below treats this question as a question of fact, on which the decision of the Tax Court must be sustained if supported by substantial evidence.[30] It is in direct conflict with a decision of the Court of Appeals for the Eighth Circuit in *Dillon v. Commissioner,* (CA 8, 1954) 213 F. 2d 218, and one of the Court of Appeals for the Tenth Circuit in *Victory Housing Co. No. 2 v. Commissioner,* (CA 10, 1953) 205 F. 2d 371, both of which considered that the identical question under the identical statute is one of law to be considered and determined by the appellate court, and both of which reversed the Tax Court's finding in the very language of the statute as a misapplication of the statute. Furthermore, inasmuch as Section 1141(a) likens the scope of review of Tax Court decisions to that of decisions of district judges, the decision below conflicts as well with two decisions of the Court of Appeals for the Fifth Circuit (*Delsing v. U. S.,* (1951) 186 F. 2d 59, and *Dunlap, Collector v. Oldham Lumber Co.,* (1950) 178 F. 2d 781), in both of which findings of district judges in the language of this same statute were held to constitute conclusions of law, fully reviewable. In both cases the trial court's determination was reversed as an error of law.

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[29]Reenacted as Sections 1221 and 1231, respectively. Because this property was used in the trade or business, Sec. 117(j), not Sec. 117(a), is the controlling section.

[30]The error in continuing to apply the substantial evidence rule to factual issues is the basis for certiorari discussed above, pp. 25-31.

The decision below also conflicts in principle with *Commissioner v. Nubar,* (CA 4, 1950) 185 F. 2d 584, holding that the questions whether a person was a nonresident alien and whether he was engaged in business within the United States were questions of law on which the appellate court was free to make an independent judgment on the facts. The second question is particularly analogous to that herein, i.e., whether a transfer was in the ordinary course of a trade or business. Clearly if one is a question of law, so is the other.

Finally, there is essential conflict between the decision below and that in *Benton v. Commissioner,* (CA 5, 1952) 197 F. 2d 745. In the latter case the Fifth Circuit held that where there was no conflict in testimony or other circumstance involving the credibility of witnesses, the appellate court must disapprove factual inferences drawn by the Tax Court from the facts if convinced the Tax Court's inferences were "clearly erroneous". The particular inference there involved was one of intent. Here, to the extent there is an inference of fact involved, it is of purpose, which is essentially the same as intent. Here there is no conflict in testimony or other circumstance involving credibility of witnesses. Most of the record is stipulated and the testimony of the principal witness was taken by deposition. Yet the Court of Appeals has refused to determine if the inferences drawn by the Tax Court are "clearly erroneous", and has, contrary to the *Benton* case, held them unreviewable if supported by substantial evidence.[31]

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[31]Compare the remarks in the "Author's Note", analyzed in footnote 24, supra p. 26.

(b) The question is important.

The question whether a so-called finding of the Tax Court in the very language of Section 117(j) of the 1939 Code and Section 2131(b) of the 1954 Code is a question of fact or one of law is an important question which has not been but should be settled by this Court. There are several supporting reasons.

(1) Since early in World War II there has been a vast shifting of population within the United States, resulting in practically doubling the population in some large areas, such as California, and in relatively smaller though nevertheless great population growths in other areas. These shifts in population caused great activity in real estate, both in the sales of residential areas and of supporting commercial and industrial areas. The very number of such sales has inevitably brought a large number of cases into the courts to determine whether or not gain or loss from such sales is capital gain or loss, which in most instances comes to depend on whether or not the taxpayer has "held (the property) primarily for sale to customers in the ordinary course of his trade or business". If this statutory expression is susceptible of authoritative definition, (a) the work of the courts in applying it in this large volume of cases will be greatly eased, and (b) the number of cases requiring litigation will be reduced since the parties will be better able to to apply the law to the facts themselves.

(2) The Tax Court has not succeeded in evolving definite standards for applying the statute. As Judge Turner stated herein (R. 105):

> "No particular test is determinative of our question. It must be decided on the facts of the individual case."

In consequence, irreconcilable decisions come from that court. We have never been able to reconcile Judge Turner's decision herein with Judge Johnson's decisions in *Louis H. Hexter, et al.*, 11 T.C.M. 337 (Carver Courts No. 3), and *The Adam Schantz, Sr. Corporation*, 11 T.C.M. 424, nor with Judge Black's decision in *South Texas Properties Co.*, 16 T.C. 1003. And cf. *Boomhower v. U. S.*, (N.D. Iowa, 1947) 74 F. Supp. 997, followed in *W. T. Thrift*, 15 T.C. 366, and *Albert Winnick*, 17 T.C. 538. Such irreconcilable decisions should not, of course, emanate from a single tribunal, but they are a natural consequence of the view expressed in the above quotation. The Court of Appeals has not helped matters, for it too, after stating the criteria evolved by the courts, concluded that they were of little help for (Appendix B, p. 81) "each case must be determined upon its own specific facts." We submit that this Court should, in the interests of sound administration of justice, insist on the evolution of standards for the application of this statute (a) so that it may be applied as uniformly as possible, and (b) so that there will be more predictability of outcome, thus promoting settlement and minimizing litigation.

(3) The evolution of at least some standards for the application of the statute is possible. The legislative history appears to have been generally ignored both by the Tax Court and the courts of appeals; yet it offers some helpful indication of what Congress meant by this language.

The statutory provision involved is the one which excludes from the definition of capital assets "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business".[32] It has appeared in the revenue laws in its present form continuously since 1934. Prior to that year it read simply "property held primarily for sale in the course of his trade or business". In 1934 Congress amended it into its present form in order to insure that stock speculators' losses would be capital losses and hence would not be fully deductible from ordinary income. H. Rep. No. 1385, 73d Cong., 2d Sess., p. 22; 1939-1 (Pt. 2) C.B. 632.

The statute says nothing expressly about corporate stock or about speculators, nor does it apply exclusively to losses. If its application is a question of fact, not of law, the Congressional intent has been thwarted, for plainly Congress thought its legislation would have uniform application to all speculators.

The statutory phrase was intended to be a term of art. Its meaning should be held by this Court to be a legal question so that it may be given uniform application in the numerous cases in which the courts are asked to construe and apply it.

FIFTH QUESTION.

The Court of Appeals and the Tax Court have both held in this case that the acquisition and subsequent holding

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[32]It appeared in both Sec. 117(a)(1)(A) and Sec. 117(j)(1) of the 1939 Code, and has been reenacted in Sees. 1221 and 1231(b)(1) of the 1954 Code.

of property with the hope and purpose of ultimately selling it for a profit are sufficient, in and of themselves, to remove any gain on condemnation or ultimate sale from the category of capital gain. In so holding, these courts have reached a result contrary to the purpose and intended effect of the statute, as disclosed by its legislative history.

The decision below presents an important question of federal law which has not been but should be settled by this Court. Moreover, it is in conflict with decisions of other courts of appeals.

(a) An important question of law is presented, which this Court should settle.

In refusing to give effect to the purpose of the statute as disclosed by its legislative history and in entering a decision likely to nullify that purpose, the Court of Appeals has decided an important question of federal law which has not been but should be settled by this Court. The statute has not been authoritatively interpreted by this Court although it has been in effect for twenty-one years.

Since the amendment in 1934 the tax statute has excluded from capital assets those assets "held . . . primarily for sale to customers in the ordinary course of . . . trade or business."[33] Both lower courts have construed this exclusion as if it read simply "held primarily

[33] "Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the year" is also excluded from capital assets. This exception has no application to real property or, except in the case of dealers, to securities.

for sale".[34] This interpretation of the statute, if not corrected, will nullify the purpose of the 1934 amendment.

The 1934 amendment changed the language of the pertinent phrase from "held . . . primarily for sale in the course of his trade or business" to "held . . . primarily for sale *to customers* in the *ordinary* course of his trade or business" (emphasis ours, indicating legislative additions). This change had its genesis in the Senate, where it

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[34]The Tax Court stated (R. 102): "We are convinced that petitioner acquired its real property in 1936 for the primary purpose of promoting and selling it for industrial use." Its discussion thereafter (R. 102-105) shows that in its opinion nothing further was required to defeat petitioner.

The Court of Appeals analyzed the facts which tended to show an original purpose of ultimate sale and then concluded (Appendix B, infra p. 92):

> "In a matter of this character, where the purpose for which the property is acquired and held, the course of conduct and the representations and admissions of the corporation, over a period of years, show that the property was held for future development as industrial sites, it would be unrealistic to hold that the leasing of property or a portion of it for agricultural purposes, pending the development or needs of the community, changed the entire complexion of the corporation so that it could be asserted that the property was held not for sale, but as a long term investment."

It then dismissed as unimportant petitioner's lack of sales activity (Appendix B, infra p. 93):

> "The fact that no subdivision was attempted has no significance. While it is the practice in California and elsewhere to subdivide property held for residential purposes or for mixed residential and business purposes, large industrial sites may derive their chief value from their availability in an undivided and unmapped tract. And it can be seen readily that it might be better business policy to keep a tract of over nine hundred acres, located on an island at Stockton Harbor, ready to satisfy the needs of large industrial plants and allow them to make their own selections, rather than relegate them to choosing from predetermined sites in a subdivided tract. Hence the failure to subdivide and break up the holdings is consistent with the purpose for which the property was held."

The Tax Court had also thought petitioner's lack of sales activity unimportant (R. 105-106).

was explained by the Finance Committee simply as being intended "to prevent tax avoidance". (S.Rep. 558, 73d Cong., 2d Sess., p. 12; 1939-1 (Pt. 2) C.B. 586, 595.) The Conference Committee, however, in accepting the Senate amendment, made its purpose clearer by stating (H.Rep. 1385, 73d Cong., 2d Sess., p. 22; 1939-1 (Pt. 2) C.B. 627, 632 [Amendment No. 66]):

> "The Senate amendment confines the exclusion to property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, thus making it impossible to contend that a stock speculator trading on his own account is not subject to the provisions of section 117."

The amendment was applicable to both gains and losses, and while it was motivated by a desire to make the exclusion inapplicable to stock speculators, its terms have never distinguished between stock speculators and speculators in land, futures[35] or any other kind of property.

The factor which distinguishes a speculator is that he has bought for the purpose of later resale at a profit. This is precisely what the lower courts held that petitioner did, and both of them considered that that was sufficient, in and of itself, to remove petitioner's property from the category of capital assets. The absence of the usual indicia of holding primarily for sale *to customers* in the *ordinary* course of business, such as continuity and frequency of sales, advertising and other sales effort,

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[35]Cf. *Corn Products Refining Co. v. Commissioner*, (CA 2, 1954) 215 F. 2d 513, cert. granted No. 457, Oct. Term, 1954. According to 23 Law Week 3170 one of the issues on which the writ was granted was the status of commodity futures as capital assets.

was shrugged off as unimportant in view of the original purpose for which the property was acquired.

If the original purpose of resale removes from the category of capital assets property held by a land speculator, such as the lower courts held petitioner was, it should do so equally for a stock speculator. The statute makes no distinction between land and stock in this respect, but purports to treat alike speculators in both types of property. Accordingly, the decision below, if followed in other cases, will nullify the legislative purpose behind the 1934 amendment.

This legislative history and its significance herein were argued to each of the lower courts. Their failure to refer to it and to attempt to reconcile it with their decision therefore must have been deliberate. We submit that no reconciliation is possible and that a decision so plainly frustrative of the legislative purpose on a broad front presents an important question of federal law which should be settled by this Court.

This tendency to restrict unduly the classification of realty as capital assets would be an important question if its consequences could be confined to sales of realty. In past years there has been unusual activity in real estate due to shifts in population, so that countless controversies are before the Internal Revenue Service and the courts in which the status of real property as a capital asset is involved. These cases are important not only because of their number but also because of their presenting so clearly the possibility of frustration of legislative purpose by decisional erosion.

Congress created the classification "capital assets" for the dual purpose of removing these occasional gains, usually of increment which grew over a long period of time, from the otherwise harsh impact of the progressive rate structure designed for the recurring, periodic type of income, and of inducing owners of appreciated long-term property to sell it and realize their profits, thus producing tax revenue which would not exist if the unabated progressive rate schedule was applicable to it. *Burnet v. Harmel,* (1932) 287 U.S. 103, 106; H. Rep. No. 350, 67th Cong., 1st Sess., p. 10, 1939-1 (Pt. 2) C.B. 168, 176. The present decision is a radical example of how time and judicial erosion have impaired the principle Congress wished to adopt.

In this case increment arising over the period 1912-1945 and realized in the latter year has been taxed not merely at the rates applicable to regular, periodic income, but has even been subjected to the nearly confiscatory excess profits tax rates. The result is to impose a liability greater than petitioner's net assets after the sale, with the result that petitioner's shareholders will have lost, not only all the profit, but even their original investments.[36]

Decisions like this one are not only in frustration of the Congressional purpose to tread lightly on long-term gains in the interests of justice, but what is potentially more serious, are in frustration of the purpose to coax

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[36]Petitioner had $300,000 after paying its debts and what it thought were its taxes (R. 59-60). The deficiencies sustained below total $266,407.81 (R. 107, 108), which with interest to the date of the decision of the Tax Court comes to over $350,000.

such gains into taxable realization.[37] Who, having petitioner's fate as an example, will sell real estate purchased for long-term profit if any other alternative is open?[38]

Since the 1934 amendment this Court has never considered this problem. It applies, in addition to realty, to stocks and securities, as to which a rule of decision has thus far been applied judicially and accepted administratively which recognizes, contrary to the decision herein, that an original purpose to hold property until it can be sold at a profit will not deprive the ultimate gain of capital gains status. *Carl Marks & Co.,* (1949) 12 T.C. 1196, Acq. 1949-2 C.B. 3; *Everett Van Tuyl,* (1949) 12 T.C. 900, Acq. 1949-2 C.B. 3; I.T. 3891, 1948-1 C.B. 69. Congress has accepted the rule of these Tax Court decisions and has established a set requirement for their application (Sec. 117 (n) of the 1939 Code; Sec. 1236 of the 1954 Code), but that legislation will become ineffective if the rationale of the decision herein is applied to stocks and securities. This will be so because the section merely states an additional requirement not theretofore imposed, and accepts implicitly, not explicitly, the propriety of the result reached in the *Carl Marks* and *Van Tuyl* cases. Nothing in this section prevents the overruling of those

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[37]Most of petitioner's gain resulted from the condemnation of its property by the United States. This, of course, increases the unfairness of this subsequent confiscation by taxation. It does not impair our argument, for the courts below clearly indicated they would have reached the same result had the sale been entirely voluntary.

[38]If an individual holds appreciated property until his death it acquires a stepped-up basis (1954 Code, Sec. 1014; 1939 Code, Sec. 113(a)(5)), so that the gain on later sale escapes income tax entirely. In this instance, then, death is more certain than taxes.

cases although such an event would make the section utterly pointless.

Furthermore, it is difficult to see what effect can be given Section 1237 of the 1954 Code, concerning sales of subdivided realty, if the rationale of the instant decision is generally accepted. This is so because that section is denied application to any taxpayer if there is any evidence, apart from the fact that he subdivided the land, that he is holding the land primarily for sale to customers in the ordinary course of business. If the courts below are correct in their view that anyone who acquires property with the hope and expectation of eventually selling it for a profit is holding it for the excluded purpose, only fortunate heirs and donees will benefit from the new provision. Yet the committee reports show Congress thought it was enacting a relief provision of some significance. S. Rep. 1622, 83d Cong., 2d Sess., pp. 115, 441-444.

We submit, therefore, that the failure below to consider and apply the legislative materials presents an important question of federal law which this Court should settle.

(b) The decision below conflicts with decisions of other courts of appeals.

The decision below, in holding that property acquired for ultimate resale is necessarily excluded from the category of capital assets, is also in conflict with the decision of the Court of Appeals for the Second Circuit in *Harriss v. Commissioner*, (1944) 143 F. 2d 279, and that of the Court of Appeals for the Fifth Circuit in *Dunlap v. Oldham Lumber Co.*, (1950) 178 F. 2d 781. In both

cases, as here, property was acquired for ultimate resale at a profit. In both cases there were more numerous sales than herein. In both cases the original and continuing purpose of resale was held not sufficient, even when coupled with more numerous sales than there were herein, to deny capital assets status to real property. The court said in the *Harriss* case (143 F. 2d at 280-281):

> "Whether property is purchased for sale in the course of business or for investment depends upon the number and the proximity of the purchases and sales to one another. A hope, when a purchase is made, that the property acquired may at some later time be sold at a profit, will not transmute a long-time investment in land held by members of a family as joint owners into a business of buying and selling real estate, or change a capital transaction into an ordinary business profit or loss."

In abandoning the tests applied in those cases and substituting a single one rejected by them, the court below decided this case in essential conflict with those decisions.

We believe that the correct view is that recently expressed by the Fifth Circuit in *Galena Oaks Corporation v. Scofield*, (CA 5, 12/29/54)——F. 2d——, 55-1 USTC 9127, in a case where there was an active business of selling houses which produced 102 separate sales in a fifteen-month period. The court said:

> "Congress intended to alleviate the burden on a taxpayer whose property has increased in value over a long period of time. When, however, such a taxpayer endeavors still further to increase his profits by engaging in a business separable from his invest-

ment, it is not unfair that his gain should be taxed as ordinary income."

That statement has no application to a case such as the one herein, where the taxpayer did not improve or subdivide its property to enhance its value or salability, where it made only a few sales without intensive sales effort, where it rented and leased its properties for nine years and then disposed of the bulk of them in two transactions, one a sale of a 240-acre farm to a farmer and the other of 600 acres to the United States pursuant to a judicial decree of condemnation. This demonstrates, we submit, the fundamental conflict between the view which was applied herein and that regularly applied in the Fifth Circuit.

CONCLUSION.

The writ of certiorari should be issued.

Dated, San Francisco, California,
February 21, 1955.

Respectfully submitted,
VALENTINE BROOKES,
ARTHUR H. KENT,
Attorneys for Petitioner.

(Appendices A and B Follow.)

Appendix A

SEC. 113(a)(7), I.R.C. 1939.

(7) *Transfers to Corporation.*—If the property was acquired——

(A) after December 31, 1917, and in a taxable year beginning before January 1, 1936, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, or

(B) in a taxable year beginning after December 31, 1935, by a corporation in connection with a reorganization,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

SEC. 362 (b), I.R.C. 1954.

(b) *Transfers to Corporations.*—

If property was acquired by a corporation in connection with a reorganization to which this part applies, then

a basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

SEC. 112 (g)(1), I.R.C. 1939.

(g) *Definition of Reorganization.*—As used in this section (other than subsection (b) (10) and subsection (1)) and in section 113 (other than subsection (a) (22)).—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E)

a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected.

SEC. 368 (a)(1)(C), I.R.C. 1954.

(a) *Reorganization.*—

(1) In General.—For purposes of parts I and II and this part, the term "reorganization" means—

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

SEC. 368 (a)(2)(B), I.R.C. 1954.

(B) Additional consideration in certain paragraph (1) (C) cases—If—

(i) one corporation acquires substantially all of the properties of another corporation,

(ii) the acquisition would qualify under paragraph (1) (C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and

(iii) the acquiring corporation acquires, solely for voting stock described in paragraph (1)(C), property of the other corporation having a fair market

value which is at least 80 percent of the fair market value of all of the property of the other corporation,

then such acquisition shall (subject to subparagraph (A) of this paragraph) be treated as qualifying under paragraph (1)(C). Solely for the purpose of determining whether clause (iii) of the preceding sentence applies, the amount of any liability assumed by the acquiring corporation, and the amount of any liability to which any property acquired by the acquiring corporation is subject, shall be treated as money paid for the property.

Committee Report (extract) re latter section. (S. Rep. 1622, 83d Cong. 2d Sess., pp. 274-275.)

Paragraph (2)(B) provides that where one corporation acquires substantially all the property of another (subsection (a)(1)(C)) if at least 80 percent of the fair market value of all the property of the other corporation is acquired solely for voting stock, the remainder of the property acquired may be acquired for cash or other property without disqualifying the transaction as a reorganization. For this purpose only, a liability assumed or to which the property is subject, is considered other property. For example, corporation A has assets worth $100,000 and $10,000 in liabilities. Corporation Y acquires $98,000 worth of assets subject to a liability of $10,000. In exchange for these assets, corporation Y transfers its own voting stock, assumes the $10,000 liability, and pays $8,000 cash. This transaction is a reorganization even though a part of the assets of corporation A is acquired for cash. On the other hand, if the assets of corporation A, worth $100,000, were subject to $50,000 in liabilities,

an acquisition of all of the assets subject to the liabilities could only be in exchange for voting stock because the liabilities alone are in excess of 20 percent of the fair market value of the property. Thus, only the rule of subsection (a)(1)(C) could be applicable.

SEC. 117 (j), I.R.C. 1939.

(j) *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of Property Used in the Trade or Business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a)(1)(C). Such term also includes timber or coal with respect to which subsection (k)(1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

SEC. 1231, I.R.C. 1954.

(a) *General Rule.—*

If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For purposes of this subsection—

(1) in determining under this subsection whether gains exceed losses, the gains described therein shall be included only if and to the extent taken into account in computing gross income and the losses described therein shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply; and

(2) losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

(b) *Definition of Property Used in the Trade or Business.—*

For purposes of this section—

(1) *General Rule.*—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in paragraph (3) of section 1221.

((2), (3), and (4) not printed.)

SEC. 1141(a), I.R.C. 1939.

(a) *Jurisdiction.*—The courts of appeals shall have exclusive jurisdiction to review the decision of the Tax Court, except as provided in Section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in Section 1254 of Title 28 of the United States Code.

SEC. 7482(a), I.R.C. 1954.

(a) *Jurisdiction.*—

The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of Title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of Title 28 of the United States Code.

Appendix B

United States Court of Appeals
for the Ninth Circuit

Stockton Harbor Industrial Company, Petitioner, vs. Commissioner of Internal Revenue, Respondent.	No. 13,615 Nov. 1, 1954

On Petition for Review of the Decision of the Tax Court of the United States

Before: ORR and CHAMBERS, Circuit Judges
YANKWICH, District Judge

YANKWICH, District Judge:

We are called upon to review a decision of the Tax Court of the United States. The main question before us is whether the petitioner, to whom we shall refer as the taxpayer, acquired its property in a reorganization and whether the money derived from a condemnation of land by the United States Government resulted in a capital gain.

I

THE SCOPE OF REVIEW

The taxpayer filed its tax return on the assumption that the basis of the land for computing its tax liability in 1944 and 1945 was its cost to it, amounting to $380,000.00 and that the gain from the sale of the condemnation of the land was capital gain. The Commissioner disallowed both contentions in his deficiency letters and his action was sustained by the Tax Court, which found:

> "That there are deficiencies in income tax for the years 1944 and 1945 in the respective amounts of $2,484.57 and $840.13; that for such years there are deficiencies in declared value excess profits tax in the respective amounts of $317.01 and $39,639.50; and that for such years there are deficiencies in excess profits tax in the respective amounts of $1,884.50 and $220,935.95."

This is a petition to review the decision. Under the provisions of the Internal Revenue Code the scope of our review, except as provided in 28 U.S.C., Sec. 1254, with which we are not concerned here, is stated to be:

> ". . . in the same manner and to the same extent as decisions of the District Courts in civil cases tried without a jury." (26 U.S.C., Sec. 1141)

In applying this provision, this court and other courts have held that it is not our function to retry questions of fact determined by the trial court upon conflicting evidence or even upon uncontradicted evidence where different inferences may reasonably be drawn from them. *Grace Bros. v. Commissioner of Internal Revenue*, 9 Cir., 1949, 173

F(2) 170, 173-174; *Rider v. Commissioner of Internal Revenue,* 8 Cir., 200 F(2) 524; *Wisdom v. United States,* 9 Cir., 1953, 205 F(2) 30, 33; *R. P. Farnsworth & Co. v. Commissioner of Internal Revenue,* 9 Cir., 1953, 203 F.(2) 490.

The Court of Appeals for the Eighth Circuit has summed up the limitations of the scope of this review in these words:

> "It is not the province of this court to retry the issues that were presented to the Tax Court. It was the province of that court to determine the facts." (*Rider v. Commissioner of Internal Revenue,* supra, p. 525)

These cases are in line with the statement of the Supreme Court that the Tax Court

> "is the agency designated by law to find and examine the facts and to draw conclusions as to whether a particular assignment left the assignor with substantial control over the assigned property or the income which accrues to the assignee. And it is well established that its decision is to be respected on appeal if firmly grounded in the evidence and if consistent with the law." (*Commissioner v. Sunnen,* 1948, 333 U.S. 591, 607)

II

THE BASIC FACTS

The basic facts as found by the Tax Court are these. The taxpayer, a California corporation, was incorporated on October 16, 1936. Ten days later it acquired certain assets of Lindley Patrick Farms, Inc., (to be referred to as Lindley Patrick) a California corporation of which Al-

bert Lindley was president, director and sole stockholder. His wife was the other director.

Between the years 1912 and 1926 Albert Lindley purchased various parcels of land totaling approximately 1,150 acres on an adjoining Rough and Ready Island, which is situated in the delta of the San Joaquin River near Stockton. The Stockton Deep Water Channel runs along the island's northern boundary to the Port of Stockton. Lindley purchased the lands for the purpose of holding them for appreciation in value which he expected would result from public improvements for navigation, with the thought that, while awaiting such developments, he could farm the land and thereby receive income or rentals.

Upon the organization of Lindley Patrick, Lindley transferred 1,110 acres of land to the corporation in exchange for all of its stock. The corporation was organized for the purpose of farming, working, developing and otherwise dealing with the properties acquired.

In 1930, further improvements for navigation were planned by public authority and were later made. The Belt Line Railroad was proposed and constructed at approximately the same time. It was about that time that a demand arose for parcels of the property for waterfront and industrial uses. Lindley Patrick undertook to sell its lands in parcels for such purposes.

By October 1, 1936, approximately 200 acres had been sold, but Lindley Patrick was in financial difficulties because of inability to pay $25,655.77 back taxes and mortgage interest. It was indebted to the San Francisco Bank

in the amount of $79,000.00, secured by a deed of trust, and to the Stockton Savings and Loan Bank in the amount of $45,595.65 and to L. F. Grimsley, Inc., in the amount of $3,557.97, both secured by a single second deed of trust. Interest on these debts had not been paid for several years, and by October 1, 1936, totaled about $20,500.00. In addition, the property was subjected to liens for delinquent county taxes in the amount of $3,767.36.

On October 6, 1936, Lindley Patrick gave Stuart L. Rawlings a written option "to purchase" its assets, the terms of which (as amended by an addendum dated October 8, 1936) were as follows:

(a) A new corporation was to be formed for the purpose of "holding, operating and selling" the real property, with a board of directors of three members, one of whom was to be Albert Lindley.

(b) "The purchase price" of the property was "to be paid" by the delivery to Lindley Patrick of 49 per cent of the new corporation's stock, subject to the payment of the principal sum of the above-mentioned promissory notes and accrued interest thereon.

(c) Rawlings was to pay to the new corporation the sum of $30,000.00 and receive 51 per cent of its stock.

(d) The $30,000.00 was to be used by the new corporation to pay the delinquent taxes and the overdue interest, and any balance was to remain in the treasury of the new corporation.

(e) Rawlings was to lend $20,000.00 to Lindley Patrick, to be secured by the pledge of its 49 per cent of the stock in the new corporation.

On October 15, 1936, the Stockton Savings and Loan Bank (which held promissory notes of Lindley Patrick on which there was a balance due of $45,495.65 secured by a second trust) bought from the San Francisco Bank its entire interest in the first deed of trust for the face amount of the principal $79,000) and overdue interest, plus one dollar for a release. E. L. Wilhoit was at that time president of the Stockton Savings and Loan Bank and is now chairman of its board of directors.

On October 16, 1936, the taxpayer was incorporated by E. L. Wilhoit, R. L. Eberhardt and Stuart L. Rawlings, each receiving one $50 share of stock. Taxpayer had a capital stock of $60,000 divided into 1,200 shares of a par value of $50 each, all of which was common stock. Its stated powers and purposes were, among other things, "to acquire, own, subdivide, develop, improve, buy, sell, lease * * * all kinds of land and personal property; * * * to transact any other kind of business that may be beneficial and desirable for the stockholders."

On October 22, 1936, the directors of Lindley Patrick resolved to deed the real property to the taxpayer, subject to the principal amount of the encumbrances, and to transfer to taxpayer a related obligation of the City of Stockton and five promissory notes made by Grant B. Shipley to Lindley Patrick, hereinafter referred to as the Shipley notes. The resolution stated "the consideration therefor to this corporation to be the sum of approximately $25,655.77 in cash, and five hundred ninety-nine (599) shares of the capital stock of" taxpayer.

Two days later, on October 24, 1936, the taxpayer's board of directors adopted a resolution to acquire from

Lindley Patrick all the real property, the related obligation of the City of Stockton and the Shipley notes. The real property was to be acquired subject to the deeds of trust securing the principal of the notes, and to the second installment of the current realty taxes. The resolution also provided that "The consideration to be paid therefor by this corporation to the said Lindley Patrick Farms, Inc., is the sum of $25,655.77 and the issuance by this corporation to Lindley Patrick Farms, Inc., of 599 shares of the capital stock of this corporation."

On the same day, October 24, 1936, the taxpayer's board of directors, also by resolution, instructed its officers to apply to the State Corporation Commission for a permit to issue additional shares of stock, for the following named considerations

E. L. Wilhoit—259 shares for $12,950
Stuart L. Rawlings—239 shares for $11,950
William Wallace Mein—100 shares for $5,000
Lindley Patrick Farms, Inc.—599 shares, for the transfer of the property subject to the encumbrances described above.

The resolution also recited that "in addition to the said 599 shares of the capital stock of this corporation, there is to be paid to the Lindley Patrick Farms, Inc., the sum of $25,655.77."

On October 22, 1936, two days prior to the date of the above resolution, taxpayer filed with the Corporation Commissioner its application for a permit to issue stock. This application stated, inter alia, that stock was to be issued for cash to the individuals above named in the total of

601 shares and that the corporation was to acquire from Lindley Patrick certain of its assets; that the 902 acres of land to be acquired from Lindley Patrick had been appraised at the sum of $418,000; "that said property is to be acquired subject to the payment of the principal sum of secured indebtedness, the total amount of which is the sum of $218,153.62", and which indebtedness was secured by five separate deeds of trust; "that the consideration to be paid by this corporation for said real and personal property is the sum of $25,655.77 and 599 shares of the capital stock of this corporation"; and "that this corporation has been formed and organized primarily for the purpose of acquiring and dealing in real estate of all kinds, and of improving, subdividing, and selling the same".

The taxpayer's officers were designated and described in the application. E. L. Wilhoit was designated as president. It was stated that for more than 25 years, he had been engaged in buying and selling real estate and that at the time was president of the Stockton Savings and Loan Bank, of Stockton, a capacity in which he had served for many years. Stuart L. Rawlings, who was shown as having been actively engaged in selling and buying real estate and as being associated with a cement company, an oil company and other corporations at that time, was designated as executive vice president. Albert Lindley was shown as vice-president and general manager. It was stated that for many years he had owned real estate situated at San Joaquin County and that he had operated his properties as farming lands, had subdivided and sold portions for industrial purposes, and was thoroughly ac-

quainted with the real property to be acquired by the taxpayer. Freda Keser, who was shown at that time to be secretary to Wilhoit, was designated as secretary and treasurer. She was described as an experienced secretary and accountant.

The permit was issued October 23, 1936. It authorized the taxpayer to issue 599 shares of its stock to Lindley Patrick Farms, Inc., for "the property and assets described in its application * * * subject to liabilities and encumbrances not exceeding in the aggregate $153,809.39". It also authorized the taxpayer to issue "601 shares to the persons named in its application at par for cash". Upon receipt of this permit, the taxpayer issued 599 shares of its stock in the name of Lindley Patrick Farms, Inc., and 601 shares to individuals of the Rawlings group.

On October 24, 1936, Lindley Patrick wrote a letter of instructions to the Security Title Insurance and Guarantee Company, the escrow agent, and transmitted with it the deed to the 902 acres of real property, the assignments to the Shipley notes and to the Stockton obligation, and also a $20,000 demand note executed by it and made payable to Stuart L. Rawlings, with a pledge agreement hypothecating its stock in the taxpayer as security for the note. In the letter, it was stated:

"6. There will be handed to you for the account of the undersigned by Stockton Harbor Industrial Company the sum of $25,655.77, which said sum is to be disbursed by you in the following manner, to-wit:

'Stockton Savings & Loan Bank—Interest on $79,000.00 note	$14,357.81
Stockton Savings & Loan Bank—Interest on $100.00 note and $45,495.65 note	6,156.47
L. F. Grimsley, Inc.—Interest on notes totaling $3,557.97	798.87
Redemption from Tax Sales	3,767.36
First Installment of State and County Taxes for 1936-1937	575.26
	$25,655.77'

All interest to be paid by October 24, 1936. After payment of the above amounts, any surplus remaining is to be paid by you to the Stockton Harbor Industrial Company.

"There will also be handed to you for the account of the undersigned, certificate or certificates for 488 shares of the capital stock of the Stockton Harbor Industrial Company, this stock to be issued in the name of Lindley Patrick Farms, Inc., Stuart L. Rawlings, pledgee.

"The deed numbered 1, assignment numbered 2, and assignment numbered 3, are to be delivered to the Stockton Harbor Industrial Company, upon the payment of the money, and the delivery of the stock as hereinabove set forth, and thereupon you are authorized to deliver the said stock in pledge, the said promissory note, and said pledge agreement, upon the said certificate of stock being properly endorsed, upon

their being delivered to you for the account of undersigned, of the sum of $20,000.00.

"Deliveries herein authorized are to be made only at the consummation of one transaction, including the conveyance of the property and the issuance of the stock, and the pledge thereof, in accordance with the terms hereinabove set forth.

"The President of the corporation is authorized to make such changes in the foregoing instructions as may be necessary to accomplish the purposes and objects thereof."

The letter was signed by Albert Lindley, as president of Lindley Patrick Farms, Inc. At the foot of the instructions is a statement, dated October 24, 1936, and signed by the taxpayer through its president, E. L. Wilhoit, as follows:

"We hand you herewith the sum of $25,655.77 which you are directed to use in accordance with the foregoing instructions, which we approve, provided nothing has transpired affecting the property subject to this escrow, since your report No. 68832 of date of October 20, 1936. We also deliver you herewith Certificate No. 8, and Certificate No. 11 for 587 and 1 share, respectively, Stockton Harbor Industrial Company Stock for delivery to Lindley Patrick Farms, Inc."

The contemplated acts by the escrow agent were carried out in accordance with the instructions received.

Lindley Patrick reported and deducted a loss from this transaction in its 1936 income tax return. The return was not audited and the claimed deduction was accordingly not disallowed.

Lindley Patrick was not dissolved prior to 1942.

At the time the taxpayer acquired "the approximately 902 acres of land" from Lindley Patrick, the land had a fair market value of $380,000. The values of the other assets acquired were as follows:

"Shipley notes—5 at $2,500	$12,500.00
Accrued interest on Shipley notes, August 5, 1936 to October 22, 1936, about	162.50
Amount due from City of Stockton	4,188.00
Accrued interest on amount due from City of Stockton	775.74
	$17,626.24"

The taxpayer acquired the real property for the purpose of developing and selling it as industrial property. It was adjacent to the Port of Stockton and gas for commercial use was available from wells approximately four miles away.

III

WAS THERE A "REORGANIZATION"?

On the basis of the above facts and others to be referred to further on in the decision, the Tax Court held that (1) the exchange of the taxpayer's stock for the assets of Lindley Patrick was a "reorganization" within the meaning of Section 112(g)(1)(C) of the Internal Revenue Code, with the result that, pursuant to Section 113(a)(7), the taxpayer's basis for the real property received was the same as that of its transferor and that (2) the real property was held primarily for sale to customers in the ordinary course of business within the meaning of Sec-

tion 117(j)(1)(B), with the result that the taxpayer's gain on the disposition of the real property is taxable as ordinary income rather than as capital gain.

It is the contention of the taxpayer that the real property was not acquired solely for stock. This is based upon the contention that in acquiring the property from Lindley Patrick, there was paid by them the sum of $25,655.77 in cash and that they assumed the unpaid indebtedness of Patrick on the property and as a condition a $20,000.00 loan was required to be made to Lindley Patrick by one of the taxpayer's shareholders. On the basis of this, it is argued that the consideration was the stock, the $25,655.77 in cash and the $20,000.00 loan.

Reorganization under the section involved means:

> ". . . the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 percentum of the total number of shares of all other classes of stock of another corporation, or (c) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded." (26 U.S.C., Sec. 112(g)(1)(B))

The last clause excluding the liabilities of the other corporation assumed by the transferee or liabilities to which the acquired property is subject, was added by the amendment of 1939 and was made retroactive to the act of 1934 (53 Stat. 871).

We eliminate at the start the $20,000.00 loan for that was not money paid in *exchange* for the voting stock. The only thing that can be considered as being involved in such exchange is money paid to the other party or for its benefit as consideration for the transfer. The only properties which can be considered are those exchanged,—*one for the other.* The $20,000.00 loan was a private transaction between one of the taxpayer's stockholders and Lindley Patrick. The money so paid was not assumed by the transferee, and while it went through the same escrow, it cannot be considered a part of the transaction. In *Commissioner v. Schumacher Wallboard Corp.,* 9 Cir., 1937, 93 F(2) 79, this Court said:

> "The cost of an article to a person is what the person pays for the same." (p. 82)

In the case of an exchange the cost is the property which goes from one to the other. The $20,000.00 loan was not a part of what the new corporation paid for the assets of its predecessor. *Hoboken Land & Improvement Co. v. Commissioner,* 3 Cir., 1943, 138 F(2) 104, 110.

There remains the question then whether the exchange was "solely" for stock under the wording of Section 112 (g)(1)(B), 26 U.S.C., so as to amount to a "reorganigation". "Solely for" means "exclusively for". It "leaves no leeway". *Helvering v. Southwest Consolidated Corp.,* 1942, 315 U.S. 194, 198.

The clause was enacted in order to overcome the ruling of the Supreme Court in *United States v. Hendler,* 1938, 303 U.S. 564. In that case there had been a merger or reorganization of the Borden Company and the Hendler

Creamery Company, Inc. resulting in gains of over $6,000,000.00 to the Hendler Company.

Pursuant to a plan of reorganization the Borden Company assumed and paid $534,297.40 bonded indebtedness of the Hendler Company. Reversing the lower court which had held that because the Hendler Company did not actually receive the money with which the Borden Company discharged its indebtedness, Hendler's gain of $534,297.40 was not taxable, the court said:

> "The transaction, however, under which the Borden Company *assumed* and paid the debt and obligation of the Hendler Company is to be regarded in substance as though the $534,297.40 had been paid directly to the Hendler Company. The Hendler Company was the beneficiary of the discharge of its indebtedness. *Its gain was as real and substantial as if the money had been paid it and then paid over by by it to its creditors.* The discharge of liability by the payment of the Hendler Company's indebtedness constituted income to the Hendler Company and is to be treated as such." (p. 566) (Emphasis added)

The Supreme Court in a subsequent case, *Helvering v. Southwest Consolidated Corp.*, 1942, 315 U.S. 194, stated distinctly that the amendment "was made to avoid the consequences of United States v. Hendler, 303 U.S. 564". (p. 199) The Tax Court in the case before us was of the view that the sum of $25,655.77 paid by the taxpayer into the escrow at the time it acquired the assets of Lindley Patrick did not constitute an additional cash consideration paid *to Patrick by the taxpayer for the property.* The property acquired by the taxpayer was acquired subject to the payment of the principal sum of secured in-

debtedness, the total amount of which was the sum of $128,153.62. The existence of this indebtedness appeared in the escrow instructions and in the many other preliminary documents which formed a part of the transaction. The price to be paid for the property was given as "$25,655.77 and 599 shares of the capital stock of this corporation".

Concededly the sum of $25,655.77 was to be paid on the accrued interest on the indebtedness and unpaid taxes, as appears from letter of instruction from Lindley Patrick dated October 24, 1936, already reproduced, which contained directions to the escrow agent as to the cash and its disposition.

It is the taxpayer's contention that the Tax Court was wrong in holding that because the money was disbursed to pay accumulated interest and unpaid taxes, it was not a cash payment to Lindley Patrick.

As the taxpayer and the Government seem to draw different conclusions from the few cases which have construed the clause introduced into Sec. 112(g)(1)(B), 26 U.S.C. by the 1939 amendment, it will be necessary to analyze them in great detail in order to see them in true perspective. When this is done, it will be seen that only when a debt, although originating in the obligation of the transferor, is of such character that its nature and amount *are determined and fixed in the reorganization*, will the Courts disregard its liquidation by cash as a part of the reorganization. And conversely, when the nature and amount of a debt arising from a pre-existing obligation are determined and fixed prior to the reorganization, the payment of cash to liquidate it is treated as a payment

on a liability assumed. In *Helvering v. Southwest Consolidated Corp.*, supra, the indenture securing bonds of an insolvent corporation was foreclosed and its properties were transferred to a new corporation pursuant to a plan of reorganization evolved by the creditors, in exchange for common stock and stock purchase warrants of the new corporation. The common stock went mostly to bondholders of the old corporation. But a small portion of it, together with part of the warrants, went to the old corporation's participating unsecured creditors, the other warrants going to the old corporation's preferred and common stockholders. Its non-participating securityholders *were paid cash*, which was obtained in the course of the transaction by means of a loan from a bank which the new corporation later assumed and paid. The Court held that the payment of cash to security holders who had declined to take the stock made the 1939 amendment inapplicable. The reason for the ruling is contained in the following paragraph:

> "The requirement to *pay cash arose out of the reorganization itself. It derived, as did the requirement to pay stock, from the plan pursuant to which the properties were acquired. It was a necessary incident of the court decree which wiped out the liability of the old corporation and substituted another one in its place. Though the liability assumed had its origin in obligations of the transferor, its nature and amount were determined and fixed in the reorganization.* It therefore cannot be labelled as an obligation of the 'other' or predecessor corporation within the meaning of the 1939 amendment. Nor can the property be said to have been acquired 'subject to' that liability within the purview of that amendment. The words

'subject to' normally connote, in legal parlance, an absence of personal obligation. That seems to be the case here, for the preceding clause of the amendment covers the case of 'assumption'." (p. 200) (Emphasis added)

In *Central Kansas Telephone Co. v. Commissioner,* 10 Cir., 1944, 141 F(2) 213, a new company, pursuant to reorganization, acquired the assets of an old company from a bondholders' committee for the voting stock of the old company. The sum of $22,470.34 cash was to be paid to a special master appointed to sell and convey the property and who was to use the money to satisfy the demands of the outstanding bondholders of the old company who had *declined to participate in the reorganization.* The new company borrowed the funds with which to make the payment and later repaid the loan. It also paid $7,690.14 as expenses of the committee and the receiver's claim of $622.98. The Court held that the payment of cash to liquidate the debt of the bondholders prevented the application of the section, that the debt arising from prior obligations only became determined and fixed in the reorganization as would also the expenses incurred in effecting the reorganization, saying:

"Here, the new company, pursuant to the plan of reorganization, paid $22,470.34 in cash to the Special Master appointed to sell and convey the assets. Pursuant to the plan, the new company acquired the assets in exchange for its stock and cash. On authority of Helvering v. Southwest Corp., supra, we hold that, *while the obligation to pay the cash had its origin in obligations* of the old company to the nondepositing bondholders, *its nature and amount were*

determined and fixed in the reorganization and that the new company, in agreeing to pay such cash, did not assume an obligation of the old company or acquire the assets subject to a liability of the old company within the meaning of the statutes referred to above." (p. 215) (Emphasis added)

A like ruling was made in *Adwood Corp. v. Commissioner,* 6 Cir., 1952, 200 F(2) 552. The taxpayer seems to find in some of the language in this opinion relating to payments to "a creditor in its own right" (p. 555) an intimation that the payment of a pre-existing debt in cash, if achieved in the process of reorganization, is a cash payment whether the obligation originated in the reorganization or not. It will, therefore, be necessary to go, with some detail, into the factual background of the case. For the statements of the opinion must be read against it.

Harry L. Pierson and Harriet P. Taylor, who are referred to as the Piersons, owned property in Detroit which they leased for ninety-nine years to Ray Spitzler and Paul L. Kamper, the lessees agreeing to build a hotel building on it. On October 20, 1925, the lessees assigned to a corporation known as the Savoy Hotel Company. Savoy and the Piersons later executed a trust indenture to secure first mortgage bonds in the principal sum of $1,450,000.00. The lease provided that upon default, the Piersons could, after notice and the lapse of three months, declare the lease terminated, in which event they could take possession and all improvements on the property would belong to them. The trust indenture provided that upon default in carrying out the terms of the mortgage, the trustee could, by a thirty-day notice to

Savoy and the Piersons, declare the principal of the mortgage due immediately.

There were several defaults by Savoy. The Piersons served notice and took possession of the premises on January 6, 1930. In the litigation which ensued over the possession the State courts confirmed the title of the Piersons.

A bondholders' committee was formed which began negotiations with the Piersons concerning a possible reorganization. On May 20, 1930, the trustee served notice on Savoy and the Piersons declaring the principal of all bonds payable immediately, and began foreclosure proceedings in June, 1930. A decree was entered on October 26, 1931, authorizing a sale of the premises forthwith unless the debt was paid. There being no adequate bid at the time the sale was continued and finally made on June 11, 1941. The property was, in the meantime, operated by the Piersons, later by the Trustee, and then by a hotel management company and the Trustee and the Piersons advanced large sums for taxes and operating expenses which became liens on the mortgaged premises prior to the lien of the first mortgage. Ten years after the foreclosure, a plan of reorganization was developed by the bondholders committee in conjunction with the Piersons and the Trustee which was approved by the Public Trust Commission on April 18, 1941. It provided for the organization of a corporation which was to purchase the property at the foreclosure sale for the benefit of the bondholders. The trustee agreed to accept $110,000.00 in settlement of its advances and to surrender for cancellation $50,000.00 face amount of first mortgage bonds which

it owned. The Piersons agreed to accept in satisfaction of their advances $65,000.00 and 2700 shares of the petitioner's stock. A deed to the hotel property was finally delivered to the petitioner, who borrowed $200,000.00 on a mortgage and paid the Trust Company and the Piersons. The holders of $6500.00 of the total bonds outstanding objecting to the plan, were paid in cash. The Tax Court found that the property was not acquired by the petitioner as a part of a reorganization. Upholding this view, the Court of Appeals for the Sixth Circuit held that the payments to the Piersons and the Trust Company were cash payments, saying:

> "Moreover, the exchange here was not only for voting stock but also for cash paid to the Piersons and the Detroit Trust Company, a creditor in its own right, as well as trustee for bondholders. That section requires that the exchange be solely for voting stock, Helvering v. Southwest Consol. Corporation, 315 U.S. 194, 62 S.Ct. 546, 550, 86 L.Ed. 789, declares the term 'solely' to be significant and holds that the fact that cash is also paid takes the case outside the operation of the section.
>
> "The petitioner claims, however, that the cash payments were pursuant to an assumption of liability of the predecessor corporation and, therefore, should be disregarded. But even were we to assume that Savoy was the transferor, *the nature and amount of the obligation was not determined and fixed until the plan of organization of the petitioner was adopted and put into effect by the agreement* between the bondholders, the Piersons and the Detroit Trust Company, Helvering v. Southwest Consol. Corporation, supra. There, the Court said 'Though the liability assumed had its origin in obligations of the transferor, its nature and

amount were determined and fixed in the reorganization.' " (p. 555-556) (Emphasis added)

So it is quite evident that this portion of the opinion read as a whole follows the gloss of the other cases in holding that cash paid on obligations, the nature and amount of which is *determined only in the reorganization*, is additional consideration. And so, whether we are dealing with (1) stockholders or bondholders who do not consent to reorganization, (2) creditors who have unliquidated claims, the nature and extent of which were not definitely determined until the reorganization, or (3) debts incurred as expenses of reorganization, we are dealing with liabilities which, in the language of *Helvering v. Southwest Consol. Corporation,* supra, although they had their "origin in obligations of the transferor (their) nature and amount were determined and fixed in the reorganization". (p. 200)

But here the cash paid into the escrow ($25,655.77) was applied to the payment of obligations of Lindley Patrick, the extent and amount of which *were fixed prior* to the reorganization. The interest he owed upon his indebtedness, he designated in his instructions to the escrow agent. The exact amount was given and the provision added "all interest to be paid on October 24, 1936". The amounts arrived at were the result of mathematical calculations based upon the amount of each indebtedness, the rate of interest and the period during which it remained unpaid. So the indebtedness as to interest was the liquidation of a debt the nature and extent of which was fixed prior to the reorganization. It *did not arise* in the reorganization. It was a pre-existing obligation which did not require

the reorganization to acquire certainty. The same is also true of the taxes. The obligation to pay taxes existed by reason of the ownership of the property by Lindley Patrick. A part of it had been sold to the State. It was necessary, therefore, to redeem from the sale. Other taxes had accrued and had not been paid. Under the law of California, taxes on real property are liens against the property assessed. California Revenue and Taxation Code, Sec. 2187. A tax on improvements is a lien on the land on which they are located if they are assessed to the same person to whom the land is assessed. Upon nonpayment of taxes and the publication of notice of delinquencies by the Tax Collector, the property is sold to the State by operation of law and the declaration of the Tax Collector. California Revenue and Taxation Code, Sec. 3436. After the sale, the property passes to the State and may be redeemed by the payment of the delinquencies to the State. California Revenue and Taxation Code, Secs. 3520 et seq. The escrow letter indicated that there was a lien on the property for the first installment of State and County taxes for the year 1936-1937 in the sum of $575.26, and that there was needed, to redeem property from tax sales, the sum of $3767.36. Clearly, then, the payment of taxes was a payment of an obligation of Lindley Patrick to redeem property sold to the State and to release the lien for the current taxes. When this was done by the transferee with the money paid into escrow, it was not necessary that there be formal agreement to that effect or assumption of the debts. No clear title could be obtained to the property without the liquidation of these taxes. The language of *Helvering v. Taylor*, 2 Cir., 1942, 128 F(2) 885 is apposite here. A corporate reorganiza-

tion was made necessary by the default on bonds, the reorganization plan providing that the new company would assume some of the debts of the old company. New bonds were to be, and were actually, issued, but it was argued because there was no direct assumption of the outstanding bond issue, there was no direct reorganization. The Court of Appeals approved the language of the Tax Court which, in effect, held that the bonds of the new company were substituted for the old and that, therefore, there was, in reality, an assumption of liability:

> "A mere statement by the new company that it assumed the obligation of the old company on its bonds would have been insufficient because they would have remained in default. Thus, a new bond issue had to be substituted for the old issue. That was one of the chief purposes and one of the chief accomplishments of the plan. *The new company in effect did assume the bonded indebtedness of the old company, since it put itself in the place of the old company and agreed to pay the amount of principal and interest owed by the old company to the very same creditors, the holders of the old bonds.* Thus, unless there is some magic in the use of the word 'assume', the present case comes within the statute." (p. 886) (Emphasis added)

So here, the delinquent taxes on property which had to be redeemed from the State, and the current taxes which were a lien upon it, were obligations on the land transferred which the corporation *assumed and paid in the escrow.*

It follows (1) that the payment of interest and taxes in the escrow was the payment of an obligation of the

taxpayer's predecessor, the extent and nature of which was fixed prior to the reorganization, (2) that the Tax Court was right in holding that the cash ($25,655.77) was not additional consideration to the seller, (3) that, consequently, the property was acquired by the taxpayer in a tax-free reorganization, 26 U.S.C., Sec. 112(g)(1)(B), and (4) that the taxpayer's basis for its real property was the same as that of its transferor. (26 U.S.C., Sec. 113(a)(7)(B)

IV

THE PURPOSE FOR WHICH PROPERTY WAS HELD

The conclusion reached upon the question of reorganization makes it necessary that we determine the correctness of the other finding of the Tax Court, that the real property was held by the taxpayer primarily for sale to customers in the ordinary course of business within the meaning of Section 117(j)(1)(B), 26 U.S.C., with the result that taxpayer's gain on the disposition of the real property is taxable as ordinary income and not as capital gain.

Under this section the term "property used in the trade or business" of the taxpayer means, among other things, real property held more than six months which is "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business". (26 U.S.C., Sec. 117(j)(1)(B)) The ruling of the Tax Court which so held is challenged by the taxpayer.

As stated in the outset, the scope of our review is limited. (26 U.S.C., Sec. 1141) We cannot substitute our

judgment for that of the Tax Court, and can only upset the findings if there is no substantial evidence to support them. What is and what is not trade or business and when property is or is not held for sale to customers are questions of fact.

Provisions similar to the one under discussion have been part of our tax statutes for many years. Courts have sought to evolve criteria by which to determine whether a person or an association was engaged in business. More particularly, they have tried to establish criteria by which to determine whether real property is held for investment or sale to customers in the ordinary course of business. Many tests have been proposed by this and other courts. Among them are: (1) the nature of the acquisition of the property, (2) frequency and continuity of sales over a period of time, (3) the nature and extent of the taxpayer's business, (4) the activity of the seller about the property, such as the extent of his improvements or his activity in promoting sales, (5) the extent and substantiality of the transactions and the like. *Richards v. Commissioner,* 9 Cir., 1936, 81 F(2) 369, 372-373; *Snell v. Commissioner,* 5 Cir., 1938, 97 F(2) 891, 892; *Burkhard Inv. Co. v. United States,* 9 Cir., 1938, 100 F(2) 642, 645-646; *Commissioner v. Boeing,* 9 Cir., 1939, 106 F(2) 305, 309-310; *Miller v. Commissioner,* 9 Cir., 1939, 102 F(2) 476, 479-480; *Ehrman v. Commissioner,* 9 Cir., 1941, 120 F(2) 607, 610; *Gruver v. Commissioner,* 4 Cir., 1944, 142 F(2) 363, 367-368; *Harriss v. Commissioner,* 2 Cir., 1944, 143 F(2) 279, 280-281; *White v. Commissioner,* 5 Cir., 1949, 172 F(2) 629, 631; *Dunlap v. Oldham Lumber Co.,* 5 Cir., 1950, 178 F(2) 781, 784; *Raw-*

lingwood Corp. v. Commissioner, 9 Cir., 1951, 190 F(2) 263, 265-266; *Palos Verdes Corp. v. United States,* 9 Cir., 1952, 201 F(2) 256, 258-259

But, in the last analysis, each case must be determined upon its own specific facts, for none of these incidences are present in all cases. And, in reviewing a finding one way or the other by the Tax Court, we must determine whether, in the light of the facts before the court, and the inferences it was free to draw from oral testimony and written documents, the conclusion is warranted.

Most of the property of the taxpayer was disposed of through a condemnation proceeding in 1945, after which only a small parcel remained which was sold for $15,-000.00.

The acquisition of private property by condemnation is a forced sale. 29 C.J.S., Eminent Domain, Sec. 2, p. 780; *United States v. Bechtold Co.,* 8 Cir., 1942, 129 F(2) 473, 476-477; *Pedrotti v. Marin County,* 9 Cir., 1946, 152 F (2) 829, 831. This Court has held a condemnation to be a "sale" under the revenue laws. *Hawaiian Gas Products, Limited v. Commissioner,* 9 Cir., 1942, 126 F(2) 4, 5.

We advert to the facts found by the Tax Court as to the activity of the corporation over the course of years. When the taxpayer acquired the property there had been some hope that gas and oil might be obtained on it, from tests that had previously been made.

In November 1937 the taxpayer entered into an oil and gas lease with certain persons who thereafter assigned their interest to Utilities Petroleum Corporation. This lease provided for an in-kind royalty of 20 per cent to

the taxpayer as lessor. It remained in effect with extensions until December 10, 1941. A well was drilled in 1941, but neither oil nor gas was found. In 1938 the taxpayer received $5,000.00 in cash income from Utilities Petroleum Corporation in connection with an extension of the lease, which it reported in its return for that year as rental income. No sale or exchange was involved.

The taxpayer did not farm its lands but leased them to farmers for agricultural purposes, including grazing. It received rentals both in crop payments and in cash. The amount received by the taxpayer as rents from agricultural tenants, as shown on its income tax returns, were as follows:

1936	100.00	1941	10,251.63
1937	4,268.01	1942	11,861.35
1938	6,319.70	1943	12,925.66
1939	6,663.23	1944	8,331.44
1940	6,231.09	1945	1,694.04

The taxpayer, upon its organization, received much publicity from the local newspapers with respect to the development of its properties for industrial uses. In 1937 it joined other organizations and individuals in honoring a citizen of a nearby community by inserting in a newspaper, the Byron Times, a display advertisement, which read as follows:

> "Best Wishes to a Great Builder on his Diamond Birthday.
>
> "In our efforts to boost the Port of Stockton throughout the years we have come to appreciate your work the more through difficulties we have encountered. Our efforts are now concentrated on de-

veloping Rough and Ready Island, across the heart of which travels great Borden Highway.

"Mr. Albert Lindley, who has owned the land for 25 years; Mr. E. L. Wilhoit, president of Stockton Savings and Loan Bank; Stuart A. (sic) Rawlings, director of Bank of California, Pacific Telephone and Telegraph Company, etc., and William Wallace Mein, noted mining engineer, president of Calaveras Cement Company and director of International Nickel Company, are financially interested in the work.

"Mr. Lindley is personally retaining his fine home on the tip of the island as well as some 400 acres adjoining the municipal wharves. Mr. Wilhoit, by adding this project to his other Delta holdings—including about 5,400 acres in Bryon Tract—has again demonstrated his faith in the lands. All of us look with confidence at the future of Port Stockton.

"And we know that future will bring you the happiness your splendid efforts have earned.

Stockton Harbor Industrial Company, Manufacturing, Industrial, Wharf and Warehouse Sites. Albert Lindley, General Manager, Rough and Ready Island, Stockton, California."

In the left-hand corner of the advertisement there was a map on which was shown the Port of Stockton and the following holdings on or adjoining the island:

"A. Oil refinery and storage tanks.

B. Proposed town site.

C. Belt Line Railroad.

1. Port Stockton Oil District and wharf.
2. Grant B. Shipley holdings.
3. Residential tract, Stockton Harbor Industrial Co.
4. Industrial tract, Stockton Harbor Industrial Co.
5. Albert Lindley holdings."

In the latter part of 1939 the taxpayer engaged an attorney as its agent to effectuate the sale of part of its property for purposes of locating a shipyard thereon, to be operated by the Kaiser interests. The agent's efforts were unsuccessful but in early 1941 he interested Rheem Manufacturing Company of San Francisco and Richmond, California, in shipbuilding and attempted to effectuate the sale of the taxpayer's property for a shipyard, to be operated by Rheem. Beginning with March 4, 1941, the taxpayer from time to time, granted the agent assignable options to purchase a part of its property and entered into written agreements with him as to the compensation he was to receive for his efforts. These written agreements were in substance the same as the prior oral agreements under which the agent had worked. In the course of his efforts, the agent concluded that the prospects for leasing a part of the taxpayer's lands for use as a shipyard were better than for sale, and, with the taxpayer's approval, he attempted to lease the property for this purpose. All of the agent's efforts to create a shipyard on the island were fruitless.

The taxpayer used stationery, the letterhead of which was as follows:

"STOCKTON HARBOR INDUSTRIAL COMPANY
WHARF, WAREHOUSE AND MANUFACTURING
SITES
STOCKTON, CALIFORNIA
E. L. Wilhoit, President; Stuart L.
Rawlings, Executive Vice-Pres.;
Albert Lindley, Vice-Pres., Gen.
Mgr., Rough and Ready Island,
Stockton, California."

On the back of the stationery, there was a map of the island and adjoining property, including the City of Stockton and the deep water channel. It showed property owned by the taxpayer, Albert Lindley and others. Above the map was the following statement:

"STOCKTON HARBOR INDUSTRIAL COMPANY
Two Miles of Water Frontage Visited Daily by
Ocean-Going Vessels and Served by Three
Transcontinental Railways."

Below the map appeared the following statement:

"Shown above is the Company's 1,000 Acres of
Manufacturing, Industrial and Warehouse
Sites—California's Inland Harbor, Center of
Production and Distribution—Solid Level
Land, Unlimited Free Fresh Water, No City
Taxes or Regulation, No Engineering Problem—
For Information Address Albert Lindley,
General Manager, Rough and Ready Island,
Stockton, California."

This type of stationery was used by the taxpayers until it sold its property to the Navy.

Part of the island, between the channel and the Belt Line Railroad, was covered by a deep overlay of sand and gravel fill which was pumped on the island when the deep water channel was being dredged in the years immediately before 1930. The fill area was unusual among delta lands for its ability to support heavy structures without need for pilings and therefore was unusually well suited to industrial, dockage and warehouse uses. The balance of the land was capable of supporting heavy structures with pilings driven to a depth of 38 feet.

In a letter to the Internal Revenue Agent in Charge, dated September 25, 1942, the taxpayer, protesting against a proposed income tax deficiency for 1939 and 1940, in part stated:

> "The corporation was organized October 16, 1936, for the purpose of holding title to real property adjacent to the Port of Stockton and with frontage extending along the San Joaquin River deep water channel. Said real property was to be offered for sale in parcels for industrial purposes. • • •
>
> "• • • The real properties of the corporation are held primarily for sale, and in event of other than a cash transaction, profit or loss would be 'accrued' upon a sale or sales of real property."

Neither Lindley Patrick nor the taxpayer subdivided the land into sites or tracts. Lindley Patrick had considered laying out the property into defined lots for sale, but preferred to treat it as all for sale and to locate individual industries, from point to point, in accordance with their respective requirements and without permitting

any haphazard or destructive selections. The taxpayer continued that policy.

In March 1942 Albert Lindley, then a director, vice-president and general manager of the taxpayer, and who operated from his residence on the island, exhibited the taxpayer's property on the island to two real estate brokers of Stockton for the purpose of acquainting them with the property and informing them of the prices at which various parcels were available for sale. It was understood that if the brokers were instrumental in bringing about the sale of any part of the properties they would receive the usual real estate agent's commission. Lindley informed them that the taxpayer was primarily interested in selling rather than leasing parcels of the property, but that consideration would be given to prospects for leases on mutually satisfactory terms.

In the normal course of events, it would take a number of years to dispose of such a large acreage as the taxpayer's island property for industrial and water frontage purposes, considering the industrial potentiality of the Stockton area.

Prior to 1942 any sales or leases of the taxpayer's property were made by direct contact between Lindley and the prospect. The taxpayer made the following sales:

"1937—13.028 acres to General Petroleum Company for $15,000.00.
1940—13.03 acres to Shell Oil Company, for $25,000.00.
1937—1.69 acres to State of California.
1940—1.78 acres to State of California."

The first two listed sales were of property fronting on the Stockton Deep Water Channel for use as oil storage and distribution facilities. The other two sales were to permit improvements by the State of California in the width and depth of the channel.

In 1943 the taxpayer sold an islet comprising 4.77 acres for $2,500.00. Selling expenses were $147.45. On April 14, 1944, the taxpayer sold 213.83 acres of land to P. Baldocchi for $42,000.00, less selling expenses of $1,139.20.

Prior to the sale to Baldocchi, the taxpayer had discussed the sale of its lands on the island to the Navy and had quoted a price of $509,550.00, in which the land later sold to Baldocchi was included at a price of $69,550.00. On August 1, 1944, an order granting the United States immediate possession was entered. The taxpayer and the United States eventually settled the fair value issue by agreeing to a price of $415,000.00 and a stipulation to that effect was filed on January 2, 1945. Judgment was entered in accordance with the stipulation and the taxpayer received payment in 1945. The taxpayer welcomed and encouraged the Navy to acquire its property on the island.

On May 23, 1945, the taxpayer sold the remainder of its real property to Albert Lindley for $15,000.00. This property consisted principally of a roughly triangular section of land across the channel from the island and adjacent to the Stockton Golf and Country Club.

After selling its property, the taxpayer's directors on July 13, 1945, adopted a resolution to dissolve. The resolution recited that the taxpayer's assets had been con-

verted into cash and instructed the officers to make a distribution in liquidation of $200.00 a share at once and to distribute the balance after the taxpayer's tax liabilities should be determined and paid. The taxpayer has not been dissolved.

In addition to these facts, most of which were undisputed, the Tax Court had before it the deposition of E. L. Wilhoit, the chairman of the board and one of the officers of the taxpayer. He had conducted negotiations for the acquisition of the property, and was instrumental in organizing the corporation for the purpose of taking over the Lindley Patrick properties.

On direct examination by counsel for the Commissioner, Mr. Wilhoit was asked the following questions:

"Q. Well in relation to the formation of the Corporation could you place it in relation to events that occurred at that time?

A. I think they investigated it before we formed the Corporation.

Q. You are not certain of that though, are you?

A. No, I wouldn't know, I am quite sure they did.

Q. Well, wasn't the primary purpose of the Corporation to develop this property and sell it for industrial sites?

A. Well, it was to farm and I suppose of course we would figure, we figured we would sell it of course like any other property we had or I had.

Q. In the disposal of the property how was it contemplated this property would be disposed of?

A. Well, that we hadn't determined at the time we bought it of course.

Q. Well, at the time the Corporation was formed there wasn't any expectation was there on the part of

the organizers that this entire property would be sold all at once was there in a lump?

A. Oh, no, no.

Q. *It was anticipated at the formation of the corporation, was it not, that it would take several years to sell this property?*

A. *Yes.*

Q. *And sell it in parcels to industrial concerns?*

A. *Different people, yes.*

• • •

Mr. Marcussen: Just to clarify the question, now wasn't the purpose in farming this land merely to get what revenue it was possible to get pending the sale of the property, Mr. Wilhoit?

A. Well not particularly, the purpose of farming it was to of course to get an income from it, that was our idea, of course we thought it would pay an income.

Q. You didn't buy the property to hold it for the purpose, however, of operating it as farm property?

A. Well, as farm property and of course one of the main things was of course this: we thought if we could get the gas or oil on it that would be—it was near town, you know, and it would be very valuable, a very valuable proposition for us if we could get gas or oil because it was so near to pipe it to town, you know. It was right on the margin of the City of Stockton.

Q. *Am I correct in saying, however, that the primary purpose of the Corporation was to acquire this land and dispose of it and sell it was it not?*

A. *Oh I suppose it was, yes, probably in some future time probably, yes, if we could.*

Q. *Well, was it not available for sale at all times from 1936 on when the Corporation was formed?*

A. *It was for sale, oh, I suppose it was yes.*

Q. *And in fact the Corporation itself made positive efforts did it not to sell this property right from the beginning of its formation?*

A. *Well, I don't know that we did from the beginning, of course we sold because we had to sell when the time came and the Navy wanted it.*

Q. When the Navy took it, but of course there had been preceding sales of various parcels from time to time?

A. Oh yes, there had been a few pieces sold.

Q. And these had been willingly entered into by the Corporation, were they not?

A. Yes."

Mr. Wilhoit was the manager of the taxpayer although he referred to Lindley also as manager.

While properties were not listed with other brokers he stated that if a sale had been made the regular commission would have been paid. He also identified advertisements, some of which are referred in the summary of facts earlier given, which, at the time of the organization of the company, stated its purpose to develop the property as industrial property and to sell it as such as the needs of the growing community warranted.

These facts indicate that the purpose of the organization of the corporation was to deal in real estate. Its property was to be developed as industrial property. Minor farming operations were conducted while waiting, as Mr. Wilhoit correctly stated, for the ultimate sale which was the object of the acquisition of the property.

The fact that the final sale did not occur for many years afterwards, when the Navy acquired the property, does not invalidate the conclusion of the Tax Court that the property was held for sale to customers in the ordinary course of trade. *White v. Commissioner,* 5 Cir., 1949, 172 F(2) 629

In a matter of this character, where the purpose for which the property is acquired and held, the course of conduct and the representations and admissions of the corporation, over a period of years, show that the property was held for future development as industrial sites, it would be unrealistic to hold that the leasing of property or a portion of it for agricultural purposes, pending the development or needs of the community, changed the entire complexion of the corporation so that it could be asserted that the property was held not for sale, but as a long term investment.

The fact that in the Articles of Corporation the right to lease was given along with the right to sell does not change the complexion of the situation. A corporation permitted to own real estate has the statutory right to lease property even if its Articles do not so provide. *California Corporations Code,* Secs. 802, 803; *McQuaide v. Enterprise Brewing Co.,* 1910, 14 C.A. 315, 319-320, 11 P 921; *Sarmento v. Bay City Land & Cattle Co.,* 1949, 94 C.A.(2) 343, 347, 210 P(2) 754.

A corporation organized for the purpose, among others, of developing large tracts of land, has the right to use the land for other legitimate purposes, such as farming, pending the ripening of the market for which it was in-

tended. Under California corporation law such acts would be considered incidental to the transaction of its business and the attainment of its corporate purposes. *California Corporations Code*, Sec. 802; *Bates v. Coronado Beach Co.*, 1895, 109 C 160, 162, 41 P 855; *Woods Lumber Co. v. Moore*, 1920, 183 C 497, 501-503, 191 P 905; *Rabbitt v. Union Indemnity Co.*, 1934, 140 C.A. 574, 582-584, 111 P 927.

The fact that no subdivision was attempted has no significance. While it is the practice in California and elsewhere to subdivide property held for residential purposes or for mixed residential and business purposes, large industrial sites may derive their chief value from their availability in an undivided and unmapped tract. And it can be seen readily that it might be better business policy to keep a tract of over nine hundred acres, located on an island at Stockton Harbor, ready to satisfy the needs of large industrial plants and allow them to make their own selections, rather than relegate them to choosing from predetermined sites in a subdivided tract. Hence the failure to subdivide and break up the holdings is consistent with the purpose for which the property was held.

Indeed, in Albert Lindley's conversations in 1945 with Captain Ernest E. Williams, the real estate agent of the Twelfth Naval District, which led to the acquisition by the Navy, and which he related to the Tax Court, Lindley "emphasized that it was industrial property and that is why he was holding it" and that "it was available for sale in parcels". Similar admissions were made in correspondence with the Bureau of Internal Revenue in 1942.

And, no doubt, the amount of the acreage and the fact that all or most of it was available in its natural state made it very desirable from the standpoint of the Navy.

In what precedes we have indicated some of the facts, representations and admissions in the record which support the conclusion of the Tax Court that the property was held primarily for sale to customers in the ordinary course of business. 26 U.S.C., Sec. 117 (j)(1)(B) Our review cannot go beyond such inquiry. *Gillette's Estate v. Commissioner,* 9 Cir., 1950, 182 F(2) 1010, 1013-1014; *Hollingswood Corp. v. Commissioner,* 9 Cir., 1951, 190 F(2) 263, 265; *Rider v. Commissioner,* 8 Cir., 1952, 200 F(2) 524, 525.

The decision of the Tax Court is affirmed.

CHAMBERS, Circuit Judge, concurring in part and dissenting in part:

I think, as to the ordinary income or capital gains question, under the evidence the Tax Court would have been justified in finding that the property either was or was not "property used in the trade or business of the taxpayer" and "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." We should not disturb the finding on this question reached upon competent evidence.

On the question of whether the Tax Court was correct in its conclusion that the transaction by which Rough and Ready Island went into Stockton Harbor Industrial Company was a tax free reorganization, I dissent from the majority opinion. While I attach no importance to the collateral transaction of the simultaneous loan made by a

stockholder of the new company to Lindley Patrick Farms, Inc., I do think the manner of handling the cash payment through escrow to pay up delinquencies on the mortgage on the property *for the account of* Lindley Patrick Farms, Inc., spoils the reorganization as a tax free reorganization, and that upon reorganization Rough and Ready Island was entitled to a new tax basis for the computation of gain.

(Endorsed:) Opinion and Concurring and Dissenting Opinion, in part. Filed Nov. 1, 1954. Paul P. O'Brien, Clerk.